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Insurance industry developments - 2006/07; Audit risk alerts

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Notice to Readers

This Audit Risk Alert is intended to provide auditors of insurance company financial statements with an overview of recent economic, technical, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards,* vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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How This Alert Helps You

This Audit Risk Alert helps you plan and perform your insurance industry audits. The information delivered by this Alert assists you in achieving a more comprehensive understanding of the business, economic, and regulatory environment in which your clients operate. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and information about current accounting, auditing, and regulatory developments.

If you understand what is happening in the insurance industry and can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining and understanding that industry information.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk). This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this Alert.

References to Professional Standards. When referring to the professional standards, this Alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients,* is referred to as AU section 317 of the AICPA *Professional Standards.*

Economic and Industry Developments

AU section 311A, *Planning and Supervision* (AICPA, *Professional Standards,* vol. 1), and AU section 311, *Planning and Supervision* (AICPA, *Public Company Accounting Oversight Board [PCAOB] Standards and Related Rules*) provide guidance for auditors regarding the specific procedures that should be considered in planning an audit. These sections state that the auditor should obtain a knowledge of matters that relate to the nature of the entity's business, its organization, and its operating characteristics. The auditor should also consider matters affecting the industry in which the entity operates, including, among other matters, economic conditions as they relate to the specific audit.

Presented in this Alert are current business, economic, regulatory, accounting, and auditing matters that may affect your clients. Reading about these matters and properly addressing them as necessary will help you gain a better understanding of your client's environment and help you better assess risks of material misstatement of the financial statements, which will strengthen audit integrity.

The State of the Economy

When planning and performing audit engagements, auditors need to understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the company's financial statements being audited.

A number of factors that could upset economic growth, possibly affecting your client's operations and therefore possibly affecting audit risk, include:

- Rising interest rates during most of the year
- Unstable oil prices
- Dangerously high and rising consumer debt levels

- Inflation concerns
- A softening housing boom in some markets

The U.S. real gross domestic product, which is the broadest measure of economic activity, increased at an annual rate of 5.6 percent during the first quarter of 2006 but slowed to a growth rate of 2.6 percent in the second quarter and 2.0 percent in the third quarter of 2006, according to the Bureau of Economic Analysis. The continued deceleration in growth into the third quarter is due, among other factors, to an acceleration in imports; a larger decrease in residential fixed investment; and decelerations in private inventory investment, personal consumption expenditures for services, and state and local government spending that were partly offset by upturns in equipment and software, personal consumption expenditures for durable goods, and federal government spending.

The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, and down from rates experienced in the prior year and the lowest since 2001.

After a period of rising rates, the Federal Reserve kept its target for the federal funds rate at 5.25 percent during its last four meetings (August through December 2006). The Federal Reserve stated, "Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters." The Federal Reserve cautioned that "readings on core inflation have been elevated and the high level of resource utilization has the potential to sustain inflation pressures. However, inflation pressures seem likely to moderate over time, reflecting reduced impetus from energy prices, contained inflation expectations, and the cumulative effects of monetary policy actions and other factors restraining aggregate demand."

Economic Impact of Hurricanes Katrina and Rita

It has been over a year since Hurricanes Katrina and Rita hit the Gulf Coast region causing catastrophic damage. The natural disasters disrupted the nation's economic growth, caused unprecedented damage, and resulted in significant private insurer losses. According to the Insurance Services Office, Inc. (ISO), Hurricane Katrina alone resulted in estimated insured losses of $40.6 billion. A year later, the United States has experienced a mild hurricane season and the Gulf Coast region continues to rebuild and recover.

Industry Trends and Conditions—Property and Casualty Sector

The U.S. property and casualty insurance industry reported extraordinary performance in the first half of 2006. The industry combined ratio was 92 percent[1] for the first half of 2006, with an expected return on equity of 14.5 percent for the year, according to the Insurance Information Institute (I.I.I.). Insurance companies were affected by record catastrophe losses in 2005; however, reduced hurricane activity during 2006 has contributed to favorable 2006 operating results, resulting in restored levels of policyholder surplus[2]. According to the ISO, the industry consolidated surplus increased by $19.7 billion or 4.6 percent in the first half of 2006, from its year-end 2005 level.

However, the industry continues to face a number of ongoing challenges including but not limited to the following:

- The possibility of above average catastrophe losses due to variable weather conditions
- A continued soft market for rates with the exception of property-related coverages
- Slow growth environment, driven in part by lower loss costs, that can lead to price competition

1. A combined ratio of 92 means that for every dollar of premium income that insurers earned during the first half of 2006, 92 cents exited in the form of claims payments, claims reserves, and expenses. The remaining 8 cents is underwriting profit.
2. Policyholder surplus is a measure of claims paying capacity or capital.

- Margin pressures as regulators limit insurers' recovery of the costs of catastrophes or reinsurance

Commercial Market

Survey data released by The Council of Insurance Agents and Brokers indicates the commercial property and casualty market continued to soften during the third quarter of 2006. Coverage is plentiful, and policies are being sold at low prices, reflecting the supply surplus in a buyers' market. Average premium rates for all commercial accounts decreased 5.3 percent during the third quarter of 2006. As premium prices fall and underwriters become more eager for new business, insurers are beginning to be more aggressive in pricing and more liberal with policy terms. This survey data released by The Council of Insurance Agents and Brokers reported that one respondent commented insurers are even becoming interested in properties generally considered unattractive, such as car dealers, restaurants, and not-for-profits. In contrast to the overall soft commercial property and casualty market, premium prices have escalated and capacity shrunk for catastrophe-exposed property throughout 2006. Catastrophe-prone property continues to experience historic high premium levels, making it difficult to secure coverage, and deductibles and exclusions continue to rise, specifically in coastal areas.

In response to increased competitive market forces, an auditor can evaluate if the client has implemented liberal policy terms, added unattractive clients, or expanded its product mix. Is product classification and valuation appropriate, considering these management assertions may become more complex if policy terms are altered? Unattractive clientele increase the risk of loss surrounding potential claim payouts, which can affect valuation complexity. Furthermore, if new products have been rapidly developed in response to changing market conditions, an auditor may consider if there has been proper management review of long-term product strategies. A company's product mix may have a significant effect on the variability of loss reserves. New products can add to the subjectivity of the loss-reserving process because of a company's lack of experience with the new product and relative lack of relevant historical data.

An auditor can refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards,* vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), which states that the auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that:

- All accounting estimates that could be material to the financial statements have been developed.
- Those accounting estimates are reasonable in the circumstances.
- The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

Personal Lines

Automobile Insurance. The I.I.I. estimates that the average premium expenditure will drop by 0.5 percent in 2007 compared with 2006. Reductions are possibly due to decreasing claim frequency coupled with only modest increases in claim severity throughout 2006. In 2006 as compared with 2005, claim frequency decreased between three percent and five percent, and the average cost per claim, which includes the cost of medical care and property damage, only rose two percent to four percent. The increase in cost per claim is modest despite the ever-increasing costs of medical care, which significantly affects automobile insurance pricing. Other reasons price reductions may occur in 2007 include competitive marketplaces, safer vehicles and roads, aggressive fraud-fighting efforts, and improvements in underwriting technology that can better assess the risk a particular driver represents. Changing demographics of the U.S. population are also contributing to cost reductions because millions of baby boomers are now considered to be in what insurers consider their safest driving years.

The auditor can evaluate the effect of the aforementioned variables on a client's operations. Evidence or expectations of increased competition, market saturation, or declining demand may lead to loosened underwriting standards and increased margin pressure. Additionally, implementation issues could surround newly implemented underwriting technology. AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), describes the objectives and components of internal control and explains how an independent auditor should consider internal control in planning and performing an audit. Among other matters, the auditor can evaluate client operational internal controls, including but not limited to the sufficiency of controls surrounding IT advances and applicable manual procedures.

Property Insurance. Many insurance companies suffered significant catastrophe losses in 2005. Some affected insurance companies had solvency ratings considered for downgrade and took actions to protect their ratings, including replacing lost capital by issuing debt or equity securities. At the same time, rating agencies' views on how to evaluate catastrophe exposure risk continue to evolve. Rating agencies have also revised their views on capital requirements and the assumptions incorporated in the various exposure models. Insurance companies are taking action to reduce their risk to catastrophes by purchasing reinsurance, which is becoming increasingly expensive as rates harden in response to demand, raising rates. Insurance companies are also trying to reduce their exposure through nonrenewals or changes in coverage or underwriting criteria.

Some of the entities designed to help insurers manage catastrophe risk have levied assessments on companies and insureds. In Florida, Citizens Property Insurance Corporation, the state-run insurer of last resort, became the state's largest home and condominium insurer. This is unsettling because the corporation was established to be an insurer of last resort rather than a major market player. A large number of high-risk clients backed by one state-run insurer depicts a plethora of undesirable clientele; economic insolvency could permeate this particular property market segment if catastrophe strikes again. In response to rising costs, consumer groups are placing increased pressure on politicians and regulators.

Many insurers make flood insurance available to their customers through the National Flood Insurance Program (NFIP) offered by the federal government. The huge volume of claims, driven by the 2005 storms, primarily Hurricane Katrina, was unprecedented and resulted in congressional action to fund NFIP payments. During 2005 and 2006, the U.S. Congress passed several bills increasing the borrowing authority of the NFIP to provide funds for payment of existing claims. Congress is currently conducting a review of payment practices by NFIP service carriers, and some members of Congress have indicated they would not agree to additional increases in borrowing authority unless significant reforms are made to the NFIP. A bill to overhaul the program died in a Senate committee when Congress adjourned in December 2006. Practitioners should remain alert to the status of this issue.

The Impact of the 2005 Hurricane Season on the Property and Casualty Sector

In 2006, insurance companies experienced significant cash outflows as they paid claims generated by the 2005 catastrophes. As noted previously, the ISO estimates that the property and casualty insurance industry will pay out an estimated $40.6 billion on claims related to Hurricane Katrina alone compared with Hurricane Andrew of 1992, which resulted in approximately $21.6 billion in payments. The ISO also estimates that overall insured losses for damage to homes, vehicles, and businesses damaged in 2005 by hurricanes are $57 billion. Readers should be aware that property catastrophe risk exposure is becoming increasingly popular with hedge funds as an alternative for portfolio diversification to enhance returns. Some hedge funds are even establishing their own reinsurance companies. Some audit risks that may be present on audit engagements as a result of the turbulent 2005 hurricane season are presented in the next section for consideration on your engagements.

Potential Audit Risk Area—Claims Expense and Loss Reserves

Claim and claim expense payments. In most cases, claim and claim expense payments originate with evidence of loss that may include signed proofs of loss, releases, medical bills, repair bills or estimates of repair costs, or invoices for fees of independent adjusters (for reinsurers, this evidence may be a notice of loss or broker's advice). When these documents are received, they are reviewed and analyzed for accuracy, consistency, and coverage under the associated policy before payment is authorized.

Liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. Under generally accepted accounting principles (GAAP), the liability for unpaid claims is based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors.

Under GAAP, consideration should be given to the guidance in Financial Accounting Standards Board Statement of Financial Accounting Standards (FASB Statement) No. 5, *Accounting for Contingencies;* FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises;* FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss—an interpretation of FASB Statement No. 5;* Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties;* SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises,* as amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification;* and the Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs,* which governs accounting and reporting if property liability loss reserves qualify as loss contingencies. Additional guidance can be found in SAB No. 92, *Accounting and Disclosures Relating to Loss Contingencies,* and SEC Financial Reporting Release No. 20, *Rules and Guide for*

Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters (SEC Release No. 6559, vol. 49 of the Federal Register, page 47,594).

Under Statutory Accounting Principles (SAP), Statement of Statutory Accounting Principle (SSAP) No. 55, *Unpaid Claims, Losses and Loss Adjustment Expenses,* provides that the liability for unpaid losses and loss adjustment expenses shall be based upon the estimated cost of settling claims incurred (including the effects of inflation and other social and economic factors), using past experience adjusted for current trends and any other factors that would modify past experience. SSAP No. 62, *Property and Casualty Reinsurance,* and SSAP No. 65, *Property and Casualty Contracts,* provide guidance on reinsurance accounting and accounting for contracts having certain features, such as claims-made policies and high deductible policies, respectively.

Auditing Considerations. Due to the increased number and complexity of transactions surrounding claims and claim expenses, especially following a catastrophic year such as 2005, inherent risk surrounding the recording and payout of claims can increase. Auditors should evaluate their client's response and adherence to criteria and related internal controls surrounding expenses.

The identification of changes surrounding valuation variables and consideration of their effect on losses are critical audit steps. The evaluation of these factors includes the involvement of specialists and input from various operating departments within the company such as marketing, underwriting, actuarial, reinsurance, and legal. Readers should remember that losses are only accrued for events that have occurred; catastrophe reserves are not allowed in anticipation of future events.

AU section 342 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. Claims expense and loss reserve estimates are significant variables on an insurance company's financial statements. Accordingly, regardless of the approach used to audit claims expense and loss reserve estimates, the auditor should gain an understanding of how management develops estimates. Additionally, Chapter 4 and Appendix A of the AICPA Audit and Accounting Guide *Property and Liability Insurance Companies,* which incorporates SOP 92-4, *Auditing Insurance Entities' Loss Reserves,* is an additional source of guidance. Moreover, Interpretation No. 2, "Evaluating Differences in Estimates," in AU section 9312A, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312A* (AICPA, *Professional Standards,* vol. 1), and Interpretation No. 2, "Evaluating Differences in Estimates," in AU section 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312* (AICPA, *PCAOB Standards and Related Rules*), clarifies guidance for evaluating differences in estimates.

Auditors can also refer to AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards,* vol. 1), as well as noting current practitioner prohibitions and restrictions that exist related to the performance of nonaudit services for audit clients, including certain actuarial services. Practitioners should be aware of and comply with these prohibitions and restrictions, including the AICPA independence rules, SEC independence rules, PCAOB independence rules, new National Association of Insurance Commissioners (NAIC) rules describing qualifications of an independent CPA included in the Annual Financial Reporting Model Regulation (Model Audit Rule) effective for 2010 statutory audits, and rules passed by the U.S. Government Accountability Office (GAO), state licensing boards, and others.

Potential Audit Risk Area—Reinsurance Recoverables

FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* provides guidance on the recording and reporting of recoveries of losses that are reinsured. Consideration should be given to the terms of the reinsurance agreements and the creditworthiness of the reinsurer. Significant payment terms may be material to liquidity and required capital levels. Some reinsurers have had to stop writing new business as a result of the strain on capital caused by losses relating to Hurricane Katrina. Whether you are the auditor of the ceding company or the assuming company, careful attention needs to be paid to the stress Hurricane Katrina has placed on the reinsurance business.

Potential Audit Risk Area—Going-Concern Sensitivities

As discussed previously, insurance companies have faced significant payout of claims during the year due to the 2005 hurricanes. An auditor can evaluate applicable agency ratings; lowered ratings can cause financial hardship for insurers. Moreover, as reinsurance rates rise, it becomes more difficult and costly for insurance companies to reduce their exposure. Many insurance companies have cancelled policies, and in some cases have stopped writing new business in catastrophe-prone areas. As a matter of course, insurance companies lacking geographically diverse clientele are more sensitive to environmental effects (such as hurricanes), which could lead to questions about an entity's going-concern assumption. Finally, lack of product line diversification can increase going-concern risks. It is important to consider your client's lines of business; businesses, home, and automobile policies are largely affected by weather variables.

Auditing Considerations. AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards,* vol. 1), requires auditors to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of an insurance companies' ability to continue as a going concern is whether the company complies with regulatory risk-based capital requirements. SAS No. 114, *The Auditor's Communication With Those Charged With Governance,* (AICPA, *Professional Standards,* vol. 1, AU sec. 380), requires that auditors communicate with those charged with governance events or conditions that, when considered in the aggregate, indicate there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. This new SAS is effective for audits of financial statements for periods beginning on or after December 15, 2006.

Industry Trends and Conditions—Life and Health Sector

Attractive 12-month equity market returns and the demand for benefit guarantees have resulted in a favorable current market for equity-linked annuity and life insurance products offered by life insurers. However, a historically lower level of general market interest rates may reduce the opportunity for growth in earnings and surplus of fixed interest life and annuity products. Life insurers have responded to these challenges by offering creative financial options in addition to traditional mortality, morbidity, and investment returns as a part of basic product offerings.

Overall, sales of individual life insurance policies have been flat for several years, but universal life products continue to experience double-digit growth, largely on the success of no-lapse guarantee products. The large number of quality life insurers competing for distribution may result in pressure on margins, transfer of certain valuable services to distributors, and the addition of more risky policyholder option features. Also, increased regulatory costs and the need for frequent product innovation are increasing administration costs for insurers.

The U.S. life insurance industry is generally well capitalized, with healthy asset quality. However, certain important elements that may affect an auditor's risk assessment include but are not limited to the following:

- Though improving, historically low investment yields may result in flat to negative profitability of in-force business and slower growth in surplus.
- Lack of available historical experience to be utilized by companies in pricing and reserving for recently issued policyholder financial options continues to affect the level of regulatory scrutiny and availability of reinsurance capacity.
- While many regulators seem to be in favor of a more principles-based approach to reserving for no-lapse guarantees, there has not yet been general agreement on a move to principles-based reserving. There remain large reserving needs for many of these contracts, causing a need to fund

the statutory strain. The auditor can refer to AU section 342, which provides guidance on obtaining and evaluating sufficient competent evidential matter to support significant accounting estimates. In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate and based on that understanding should use one or a combination of approaches included in AU section 342.

- Hedging programs developed by insurers in recent years to manage exposures to policyholder financial options have not been tested in more volatile markets. Additionally, increased volatility adds to the cost of hedging strategies, which could either reduce insurers' profitability or result in additional risk. The auditor can refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, Professional Standards, vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), which provides guidance to auditors in planning and performing auditing procedures for assertions about derivative instruments, hedging activities, and investments in debt and equity securities.

General Market Interest Rates and Interest Spread Compression

Although improving recently, general market interest rates remained relatively low for an extended period of time, which has resulted in a continuing decline in portfolio rates of return. This is an important issue for insurers with fixed interest annuity and life insurance products. For many life insurers, portfolio rates have approached levels needed to support minimum rates guaranteed to policyholders; therefore, some insurers have limited ability to reduce crediting rates in the event of further declines in portfolio yields. Previously, most insurers had been able to adjust crediting rates, and the recent rise in market interest rates has resulted in new money rates not significantly different from portfolio rates. Further moderate increases could improve insurers' profitability, but a significant and sustained increase in new money rates could result in a disintermediation between assets and liabilities and other-than-temporary impairments of invested assets.

Much attention has been given to the topic of other-than-temporary impairments, particularly those that may arise from increases in general market interest rates or increases in sector spreads. Other-than-temporary impairments may significantly affect life insurers' earnings as interest rates increase, causing certain securities to be impaired. Companies may need to record an impairment even if a decision to sell has not been made. One factor in not recording an impairment is whether the company has the positive intent and ability to hold these impaired securities until recovery or maturity. This may limit their ability to sell the securities. There may be situations under which a change in facts and circumstances would allow companies to subsequently change their intent to hold the securities until forecasted recovery.

Statutory accounting does not subject insurers to this impairment model. Rather, impairments related to interest rates or sector spreads are recorded when there is an intent to sell the related security. For additional information on other-than-temporary impairments, see the discussion regarding "Security Valuation Developments" in the "Audit and Accounting Issues and Developments" section of this Alert.

Regulatory and Legislative Issues and Developments

Regulatory Risk—General Governmental

Many industry executives believe, notwithstanding the catastrophe losses incurred by property casualty insurers, that regulatory risk is the biggest challenge faced by insurance companies. Whenever new laws are passed, there is risk of noncompliance due to error or oversight. Auditors need to keep abreast of the developing legislation because changes can affect management's assertions.

Currently, the use of credit-scoring for ratings is still opposed by regulators in certain jurisdictions. Debate continues over regulatory modernization, rate regulation, and a greater role for federal regulation. Additionally, after several failed attempts, Congress may still consider other proposals to establish a trust fund to resolve asbestos injury liabilities. Of the many regulatory issues and developments, some significant issues and developments to consider on your audit engagements are presented in the following paragraphs.

Modernizing Insurance Regulation

While the insurance industry has traditionally been regulated by individual states, many in the industry view the current system of state regulation as overly complex, costly to comply with, and anticompetitive and burdensome in that it slows the process of bringing new products to the marketplace. In response, reform proposals have been introduced to modernize insurance regulation. According to a December 2006 I.I.I. update, reform proposals are currently moving in two directions: (1) a dual federal and state system where insurance companies could choose between the state system and a national regulatory structure or (2) modernization of the current state system. Optional federal charter bills (bills that would give insurers the ability to choose between state and federal regulation similar to the banking industry) were introduced in the House of Representatives and the Senate during the last session. If similar bills, in either of the reform directions, are introduced in the future, they could significantly affect insurance regulation. Auditors should remain alert to the progress of these reform initiatives.

Additionally, the McCarran-Ferguson Act is under renewed scrutiny from a number of sources. The McCarran-Ferguson Act, signed into law in 1945, declared states would continue to regulate insurance and granted insurers a limited exemption from federal antitrust legislation. The exemption in the McCarran-Ferguson Act permits insurers to jointly develop common insurance forms and share loss data to help them price policies. A bill was introduced in early 2006 curtailing the insurance industry's exemptions under the McCarran-Ferguson Act. Auditors should remain alert to the potential for further developments regarding this issue.

Industry Investigations

Over the past several years, there have been investigations of industry practices by the SEC, the U.S. Justice Department, the New York Attorney General, and others focused on industry broker compensation practices, including prohibiting the payment of contingent commissions by insurers to brokers, and, by certain companies, bid-rigging schemes, improper accounting for finite reinsurance transactions, and improper reporting of premiums to avoid assessments. For further information, see the discussion of "Reinsurance Arrangements" in the "Audit and Accounting Issues and Developments" section of this Alert.

Terrorism Risk Insurance Act

Congress passed the Terrorism Risk Insurance Act (TRIA) in November 2002 after the September 11, 2001, terrorist attack. TRIA provided for a program that, in the event of a major terrorist attack, allows the insurance industry and federal government to share losses according to a specific formula. This program allowed development of a terrorism insurance market as insurers' losses are limited. The Terrorism Risk Insurance Extension Act of 2005 provided for an extension for two additional years, expiring at the end of 2007. Whether this legislation will be further extended is uncertain. If TRIA is not renewed, carriers may have a significant increase in retained catastrophe loss exposure from terrorist acts, especially with respect to worker's compensation coverage for which the exposure cannot be excluded. Further details of the Terrorism Risk Insurance Extension Act of 2005 are included in the "Terrorism Insurance Developments" section of this Alert.

Property and Casualty Sector—Assessment Facts and Circumstances

Elevated hurricane activity over several prior seasons has increased assessments levied by state-sponsored residual market insurers, high-risk insurance pools, catastrophe funds, and similar structures (structures). Many states have structures that provide coverage (including reinsurance) in high-risk areas or for high-risk insureds. Certain of these structures operate as insurance companies, reinsurance companies, or both and have the ability to assess insurers[3] operating in their respective state in the event that the structure's fund has insufficient amounts to pay claims.

Auditors may need to determine if their client has identified all of the structures that could result in future assessments and gain an understanding of all structures that could materially affect the client. To gain an understanding, an auditor can either directly contact the structure or access the structures' Web sites to obtain the necessary regulatory information about the plan's operations to assess the reasonableness of the assessments recorded in the financial statements. Some structures to consider are included in the following table.

Structures to Consider	*Web site*
Citizens Property Insurance Corporation of Florida (Florida Citizens)	www.citizensfla.com
Florida Hurricane Catastrophe Fund (FHCF)	www.sbafla.com/fhcf
Texas Windstorm Insurance Association (TWIA)	www.twia.org
Louisiana Citizens Property Insurance Corporation	www.lacitizens.com
The Mississippi Windstorm Underwriting Association (MWUA)	www.msplans.com/mwua
The Mississippi Residential Property Insurance Underwriting Association (MRPIUA)	www.msplans.com/MRPIUA
Alabama Insurance Underwriting Association (AIUA)	www.alabamabeachpool.org

Changing requirements of structures that affect how such structures are organized or funded increase the risks associated with regulatory compliance, accounting practice, and auditing considerations surrounding management's assertions. A crucial step toward obtaining audit assurance is to be aware of potential pitfalls surrounding assessment facts and circumstances during the plan-

3. Insurers can directly surcharge their customers to recoup any surcharges made against them by the structures. Specific accounting is discussed later in this section.

ning stages of the audit and thereafter. Some questions to consider are listed in the following paragraphs.

Has the client properly identified the type of assessment category (or categories) levied by the regulatory structure? SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments,* defines four guaranty-fund assessment categories, namely, retrospective-premium-based, prospective-premium-based, prefunded-premium-based, or administrative assessments.[4] Under SAP, SSAP No. 35, *Guaranty Fund and Other Assessments,* does not distinguish between retrospective- and prospective-premium-based assessments and instead treats all premium-based assessments similarly to the retrospective-premium-based assessments described in SOP 97-3. Structures levy assessments based upon specific regulation. For example, Florida Citizens and Louisiana Citizens Property Insurance Corporation both levy retrospective-premium-based assessments. Other structures may levy different types of assessments. Problems in determining the proper assessment type can affect whether an insurer has applied the appropriate accounting and disclosure because the assessment type affects the timing of recorded liabilities and related disclosures. For example, if a structure is limited to annual assessment caps with remainders recovered through future years' assessments, those future assessments may be categorized as either retrospective or prospective for GAAP reporting, depending on the specific structure and state regulations.

Has the client maintained compliance with current legislation? Lack of compliance can skew management's assertions. For example, under SAP, Interpretation 03-01, *Application of SSAP No. 35 to the Florida Hurricane Catastrophe Fund,* which provided 2003 guidance specific to the FHCF, has not been updated for 2004 FHCF legislative changes, which now require insurers to act as agents. Insurers now collect assessments from policyholders, rather than being initially liable for the assessment and passing this cost on through additional premiums as was previously the case. Interpretation 03-01 is no longer authoritative for assess-

4. For additional discussion, see SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments.*

ments levied by the FHCF and is currently being revised by the NAIC. Lack of familiarity with this new legislation could cause an overstatement of liabilities. Paragraph 10 of SSAP No. 35 states that when the reporting entity acts as an agent and (1) the assessment is reflected as a separately identifiable item on the billing to the policyholder and (2) remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured, the liability for fees and assessments rests with the policyholder rather than with the reporting entity, and the assessment is not reported in the insurer's statement of operations. Your client's obligation may be to collect and subsequently remit the fee or assessment.

Has the client inappropriately applied analogous interpretation of GAAP or SAP? In the aforementioned example, the interpretation passed was applicable only to the FHCF. The auditor should be alert that any structure-specific guidance is not inappropriately applied by analogy to other structures.

Has the assessment met all requirements for recognition? Management's assertions of completeness and valuation (including related presentation and disclosure) are affected by difficulties surrounding timing and estimation. In accordance with GAAP, in paragraph 10 of SOP 97-3, the following three criteria must be met for your client to recognize liabilities for insurance-related assessments:

1. Has an assessment been imposed or information of a probable assessment levy occurred prior to the issuance of the financial statements (this includes the subsequent events period)?

2. Did the event obligating an entity to pay an imposed or probable assessment occur on or before the date of the financial statements? Note that the term *event* may mean more than one event per paragraph 36 of SOP 97-3. For example, for natural catastrophe retrospective-premium-based assessments, the triggering events are both the occurrence of the catastrophe and the writing of the premium that obligates the entity for the assessment liability.

3. Is the amount of the assessment reasonably estimable?

Has the client accounted for SAP and GAAP timing recognition differences that arise due to the type of assessment? As mentioned previously, under SAP, SSAP No. 35 rejects some of the guidance in SOP 97-3 and does not distinguish between retrospective- and prospective-premium-based assessments. Instead, all premium-based assessments are accounted for in a manner similar to retrospective-premium-based assessments, as described in SOP 97-3. Note that in certain instances, SAP does parallel FASB Statement No. 5 accounting because paragraph 6 of SSAP No. 35 states that loss-based assessments are presumed probable when the losses on which the assessments are expected to be based are incurred.

Has management's methodology for valuing assessment liabilities been consistent from period to period? Current practice allows (but does not require) the discounting of aggregate obligations if the amount or timing of payments are "fixed or reliably determinable." Due to increased assessments over the past several years, management's consistency surrounding discounting choices needs to be carefully evaluated. The auditor should also note if all necessary disclosures relating to FASB Statement No. 5, FASB Interpretation No. 14, and SOP 94-6 are present.

Has the client properly managed delays in obtaining information used in the estimates? In some cases, current-year assessments are based upon prior-year data, and delays may occur obtaining assessment valuation information. Under GAAP, paragraph 3 of FASB Interpretation No. 14 states that when no estimate within a given range is better than another, the liability should be the minimum amount in the range. Under SAP, paragraph 10 of SSAP No. 5, *Liabilities, Contingencies and Impairments of Assets,* states that when the reasonable estimate of the loss is a range, the amount in the range that is considered the best estimate shall be accrued. However, when in management's opinion no amount within management's estimate of the range is a better estimate than any other amounts, the midpoint (mean) of management's estimate in the range shall be accrued. If management determines that the high end of the range cannot be quantified, a range does not exist, and management's best estimate should be accrued.

Has the client accounted for assessments not officially levied by applicable structures? Paragraph 16 of SOP 97-3 states that an entity need not be formally notified of an assessment by a structure to make a reasonable estimate of its liability. Auditors may need to note if clients have included assessments in the reporting period to avoid unrecorded liabilities. Paragraph 16 continues to state that entities subject to assessments may have to make assumptions about future events, such as when the fund will incur costs and pay claims that will determine the amounts and the timing of assessments. Similarly, under SAP, SSAP No. 35 provides that entities subject to assessments may have to make assumptions about future events, such as when the fund making the assessment will incur costs and pay claims to determine the amounts and the timing of assessments.

Has the client waited for board of director (or other authoritative) approval to recognize assessments levied, or not yet levied, by applicable structures? Authoritative approval is not the trigger that determines loss as defined in FASB Statement No. 5. Contingent liabilities are recorded when probable and reasonably estimable. Clients need to determine whether an assessment is probable and measurable and then, consistent with the provisions of FASB Statement No. 5, determine if recognition or disclosure is warranted. Similarly, paragraph 4 of SSAP No. 35 requires that a liability should be recognized when (1) information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements and (2) the amount of the liability can be reasonably estimated.

Has the client accounted for SAP and GAAP timing differences when recognizing and valuing potential future policyholder premium surcharges and premium tax offsets? For property and casualty companies, the majority of contracts are of short duration. Under GAAP, paragraph 22 of SOP 97-3 states that assets are recognized for recoveries of amounts based on current laws and projections of future premium collection or policy surcharges from in-force policies (with appropriate valuation allowances established). This does not include expected renewals of short-duration contracts but does include assumptions as to persistency rates for long-duration contracts. In-force policy restriction applied to a short-duration contract product line usually means that asset recognition is limited. However, under SSAP No. 35, an asset may be recognized (gross) for premium tax credits and for policyholder surcharges that will be collected in the future to the extent the asset is probable of realization (with appropriate valuation allowance being recorded).

Has the client recognized policyholder surcharges for amounts that are, in substance, pass-through funds? Policy surcharges are recognized for in-force policies when appropriate. However, some structures require the insurer to collect policyholder surcharges from insureds for state (and other structure) assessments for future premiums and to remit the surcharge to the state or other regulatory body on behalf of the policyholder. Paragraph 26 of SOP 97-3 clarifies that amounts for receivables and surcharges collected that pass through the insurance entity to the state or other regulatory body should not be recorded as revenues and that amounts due or paid are not expensed. Under SAP, SSAP No. 35 provides that such surcharges shall not be reported in the insurer's statement of operations when both of the following conditions are met:

1. The assessment is reflected as a separately identifiable item on the billing to the policyholder.
2. Remittance of the assessment by the reporting entity to the state or federal agency is contingent upon collection from the insured.

Is the transaction related to an assessment or reinsurance? Certain structures operate as both assessors and reinsurers. Under GAAP, assessments should be accounted for under SOP 97-3, and reinsurance transactions and certain involuntary pools should be accounted for under FASB Statement No. 113. Under SAP, assessments should be accounted for under SSAP No. 35; reinsurance transactions under SSAP No. 62; and certain involuntary pools under SSAP No. 63, *Underwriting Pools and Associations Including Intercompany Pools.* Insurers ceding business under reinsurance agreements would record ceded premiums for premiums paid to the fund and ceded losses (not assessment liabilities) for recoveries from the fund.

Have reinsurance contract variables been properly evaluated? As with all insurance contracts, risk transfer criteria need to be analyzed and the asset needs to be evaluated for collectibility from the reinsurance structure. Timely collectibility may be in question if a reinsurance structure's fund is depleted, which may be the case for some structures after recent catastrophes, although ultimate collectibility may not be at risk if the structure of the fund provides for the assessment of all insurers writing business in the affected state until such time as the fund is replenished. The contract should also state how amounts recoverable are calculated. There also should be consideration whether there is an obligation for the ceding company to repay the reinsurance structure if the ceding company does not collect the amount from policyholders through future policy surcharges. For additional information on reinsurance, see the "Reinsurance Arrangements" section of this Alert.

Life and Health Sector—Guarantees and Other Developments

Minimum Guaranteed Death Benefits and No-Lapse Guarantee Mortality Features

Variable annuity products that contain minimum guaranteed death benefits (MGDBs) or guaranteed minimum income benefits (GMIBs) pose additional consideration, which include the following:

- Companies may experience general account charges for the payout of these benefits (upon either death or annuitization, as applicable) when the market value of the separate account assets is not sufficient to support the level of benefit payment.
- GAAP and SAP may require insurers to establish reserves for variable annuity guarantees on these products, thereby placing strain on capital strength.

The NAIC's Risk Based Capital C3 Phase II initiative requires cash-flow testing for annuities or other products with exposure to interest-rate risks. Interest-rate risk may increase if there is a duration mismatch between assets and liabilities. Testing includes multiple scenarios with various interest rate fluctuations to determine whether reserves are adequate. This testing may cause some life insurers to increase their capital requirements for interest-sensitive products.

Companies that issue universal life insurance with no-lapse guarantee mortality features are subject to the provisions of SOP 03-1, *Accounting and Reporting by Insurance Enterprises for Certain Nontraditional Long-Duration Contracts and for Separate Accounts,* and should establish liabilities in addition to account balances if amounts assessed each period for the feature are expected to result in profits in earlier years followed by losses in subsequent years.

SOP 03-1 contains guidance for accounting for MGDBs, GMIBs, and no-lapse guarantee features. These features are also addressed in FASB Staff Position (FSP) FAS 97-1, *Situations in Which Paragraphs 17(b) and 20 of FASB Statement No. 97,* "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments," *Permit or Require the Accrual of an Unearned Revenue Liability,* and in AICPA Technical Practice Aid (TPA) section 6300.08, "Definition of an Insurance Benefit Feature." Management should be familiar with all of these pronouncements in applying the guidance in SOP 03-1. Auditors should also gain an understanding of these pronouncements, depending upon the circumstances at their clients.

Regulation XXX/AXXX Considerations

State insurance regulators adopted regulation XXX in 2000 to provide for the cost of renewal guarantees in term insurance products. Later, universal life no-lapse guarantees based on the payment of minimum premiums were also covered by this regulation. In 2003, state regulators adopted AXXX, intended to capture secondary guarantees covered by other policy designs. It states, "Reserves need to be established for the guarantees provided by a policy." In many cases, life insurers have transferred the reserve requirements under these regulations to off-shore reinsurance companies. As a result of significant growth in term insurance renewal guarantees and universal life no-lapse guarantees, some knowledgeable parties predict that the availability and cost of bank letters of credit backing offshore reinsurance could be severely affected within the intermediate future. Also, subsequent interpretation of these new regulations may result in some insurers being required to post additional statutory reserves to cover no-lapse guarantees.

The NAIC formally adopted a change to AXXX that affects policies written after the effective date of July 1, 2005. It is anticipated that the change to AXXX will result in higher capital and reserve requirements, price increases for universal life policies with secondary guarantees, and revised product designs. Some life insurers are expected to use affiliated reinsurance relationships to cede these additional reserves, thereby decreasing the effect on earnings and return on equity. The change to AXXX will be in effect for two years, at which point it is expected that a principles-based approach for determining statutory reserves will be in place. On June 1, 2006, the NAIC legal staff ruled that state insurance commissioners may include lapse rates in their interpretation of Actuarial Guideline 38 when they formulate reserve requirements, and several key regulators are on record of supporting this action. This ruling may allow insurers to hold lower reserves while industry regulators and actuarial groups continue to work on a permanent rule to adopt principle-based reserving practices for statutory purposes. However, the timing and certainty of principles-based practices are not definite and probably will not occur within the upcoming audit year.

Recent SAP

The NAIC continues to create and clarify statutory accounting guidance for insurance enterprises through its ongoing maintenance process. The most recent NAIC *Accounting Practices and Procedures Manual* (Manual) was published by the NAIC as of March 2006. For Manual subscribers, modifications made subsequent to the publication of the Manual are available from the NAIC Web site at www.naic.org. Insurance laws and regulations of the state insurance departments require insurance companies domiciled in those states to comply with the guidance provided in the Manual, except as otherwise prescribed or permitted by state law or regulation.

The 2006 Manual contains two new SSAPs adopted during 2005 and effective for implementation as of January 1, 2006:

1. SSAP No. 90, *Accounting for the Impairment or Disposal of Real Estate Investments,* replaces paragraphs 9, 10, and 19 of SSAP No. 40, *Real Estate Investments,* and provides statutory accounting guidance concerning when and how to account for an impairment or disposal on a real estate investment or long-lived assets associated with discontinued operations in light of the guidance set forth in FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.*

2. SSAP No. 93, *Accounting for Low Income Housing Tax Credit Property Investments,* requires that investments in Low Income Housing Tax Credit properties be carried at the lower of amortized cost or fair value, a change to the previous requirement of using the equity method of accounting for these types of investments under SSAP No. 48, *Joint Ventures, Partnerships and Limited Liability Companies.*

In 2005, SSAP No. 62 was amended to require additional reinsurance information to be disclosed in new reinsurance interrogatories beginning with the 2005 annual statement. During 2006, the reinsurance interrogatory requirement was further amended by limiting the reinsurance contracts to be included in this interrogatory to those contracts having an underwriting effect, written premium ceded, or loss and loss expense reserves ceded greater than five percent of the prior year surplus, effective for 2007. The current limitation of three percent of surplus remains in effect for 2006 reporting. Beginning in 2006, these new reinsurance interrogatories are required to be included as accompanying supplemental schedules to the annual audited financial statements of insurance companies. It was proposed that the information included in the supplemental schedules to the audited financial statements be limited to reinsurance contracts entered into, renewed, or amended on or after January 1, 1994. During the 2006 winter NAIC meeting, the SAP Working Group adopted this proposed change to narrow the scope of disclosure to reinsurance contracts entered into, renewed, or amended on or after January 1, 1994. The disclosures will be included in the 2006 audited financial statements for the first time. This limitation to post-1994 contracts does not apply to the disclosures in the annual statement interrogatories; therefore, information included in the annual statement interrogatories may be different than disclosures in the audited financial statements, depending on whether the company has any pre-1994 contracts.

As of the date of this writing, the following new SSAPs will become effective in 2007:

1. SSAP No. 95, *Exchanges of Nonmonetary Assets, A Replacement of SSAP No. 28—Nonmonetary Transactions,* adopts the guidance in FASB Statement No. 153, *Exchanges of Nonmonetary Assets—an amendment of APB Opinion No. 29,* which introduces the concept of commercial substance in nonmonetary exchanges of similar productive assets. SSAP No. 95 allows for an exception to measuring exchanges of nonmonetary assets at fair value when the nonmonetary exchange of similar productive assets does not have commercial substance. This SSAP should be applied prospectively and is effective for periods beginning after January 1, 2007.

2. SSAP No. 96, *Settlement Requirements for Intercompany Transactions, An Amendment to SSAP No. 25—Accounting for and Disclosures about Transactions with Affiliates and Other Related Parties,* requires that terms of transactions between related parties be defined in a written agreement and that the agreement must provide for timely settlement of amounts owed, including specified due dates. Any amounts owed to the reporting entity over 90 days past the

due date or not specifically addressed in a written agreement should be non-admitted. This SSAP was approved as final at the NAIC 2006 winter meeting. The NAIC SAP Working Group agreed to revise the effective date from January 1, 2007, to December 31, 2007.

Since the adoption of SSAP No. 88, *Investments in Subsidiary, Controlled, and Affiliated Entities, A Replacement of SSAP No. 46,* in 2005, a number of implementation questions have arisen from the industry and regulators. In response to these inquiries, the SAP Working Group is in the process of finalizing an implementation guide that will be adopted as an appendix to SSAP No. 88. This appendix will be in the form of a series of questions and answers and should clarify the intent of the guidance and ensure that insurance companies are properly recording the value of subsidiary, controlled, and affiliated entities.

Additionally, six new interpretations were adopted during 2005 and incorporated into the revised Manual. As of the date of this writing, five new interpretations have been adopted that are effective for 2006. Additionally, several *nonsubstantive* revisions to various SSAPs and changes to the appendices were made during 2005 and 2006 by the NAIC.

Federal Medicare Part D Prescription Drug Programs

The Medicare Prescription Drug Improvement and Modernization Act of 2003 established a new voluntary Medicare Prescription Drug Program (Medicare Part D) for which benefits started on January 1, 2006. The benefit has a $250 deductible for 2006 with $50 annual increases each year after. For 2006, the initial coverage limit is $2,250 with $10 annual increases each year after. The coinsurance percentage associated with initial coverage is 25 percent. Finally, the benefit has an out-of-pocket threshold and an associated secondary coinsurance percentage. After total costs paid by the enrollee (including the deductible and the coinsurance under the initial coverage limit) exceed the out-of-pocket threshold, the enrollee is only responsible for a proportion (namely, the coinsurance percentage) of any further drug costs. For 2006, the out-of-pocket threshold is $3,600 with $50 annual increases each year after. The coinsurance percentage associated with costs above the out-of-pocket threshold is five percent

There are provisions in the regulations that authorize certain types of alternative benefit designs as long as the benefits provided are certified as being actuarially equivalent to the standard design. The regulations also permit a prescription drug plan (PDP) sponsor to offer enhanced alternative coverage, in which at least one key aspect of the benefit design (deductible, cost sharing, or initial coverage limit) is richer than the standard plan. Such additional benefits are referred to as *supplemental benefits* in the regulations. Many companies are expected to develop enhanced alternative coverages that provide insurance benefits for claims above the initial coverage limit, even though the standard out-of-pocket threshold may not have yet been satisfied. The Centers for Medicare & Medicaid Services (CMS) will reimburse PDP sponsors for 80 percent of all claims above the out-of-pocket threshold. To the extent that the PDP sponsor's adjusted allowable risk corridor costs vary in either direction from a target amount, there is risk sharing between the CMS and the PDP sponsor. No sharing occurs if actual costs are within 2.5 percent of the target. A 75 percent and 25 percent sharing occurs for costs between 2.5 percent and 5 percent of the target. Costs in excess of 5 percent of the target are shared 20 percent and 80 percent by the PDP sponsor and CMS, respectively.

Accounting and Auditing Considerations

In this section is a list of several factors that the auditor may need to be aware of when auditing Medicare Part D Programs.

Contract classification. How should the underlying contract with the beneficiary be classified under FASB Statement No. 60? The underlying contract with the beneficiary in Medicare Part D Programs generally provides health insurance (prescription drug) coverage for periods of one calendar year with premiums adjustable annually.

Premiums. How should premiums be recognized? Premiums paid by the beneficiary, either directly to the plan sponsor or through withholding from Social Security checks and remitted from Medicare, are composed of up to three components:

1. The base beneficiary premium is a fixed amount that, for the standard benefit plan, is intended on average to represent 25.5 percent of the program costs.

2. The supplemental benefit premium is a fixed amount, applicable only to an enhanced alternative coverage, representing the additional cost of supplemental benefits.

3. The late enrollment fee is a penalty assessed to beneficiaries who enroll outside of the normal enrollment windows, reflecting the possibility of adverse selection.

Incurred Claims. How should claim costs be accrued? In accordance with FASB Statement No. 60, losses should be accrued as incurred.

Risk Sharing. How should risk corridor payments be accounted for? Medicare Plan D Programs provide a risk-sharing arrangement whereby actual results for the plan sponsor are compared to the targeted results anticipated in the plan sponsor's bid accepted by Medicare. Threshold limits for payments to or from Medicare will be determined based upon symmetric risk corridors around the target amount as discussed above.

Because of the unique nature of Medicare Part D Programs, there have been two methods utilized in practice for accounting for the risk corridor payments:

1. A retrospective refund arrangement under paragraph 44 of FASB Statement No. 60, based on the experience to date following a model based on FASB Emerging Issues Task Force (EITF) Issue No. 93-14, "Accounting for Multiple-Year Retrospectively Rated Insurance Contracts by Insurance Enterprises and Other Enterprises" (EITF Issue No. 93-14 is based on EITF Issue No. 93-6, "Accounting for Multiple-Year Retrospectively Rated Contracts by Ceding and Assuming Enterprises," and identifies the guidance in EITF Topic No. D-35, "FASB Staff Views on Issue No. 93-6, *Accounting for Multiple-Year Retrospectively Rated*

Contracts by Ceding and Assuming Enterprises," related to EITF Issue No. 93-6 as relevant guidance for applying EITF Issue No. 93-14).

2. A retrospective premium adjustment on a retrospectively rated contract in accordance with paragraph 14 of FASB Statement No. 60. This paragraph indicates that if the ultimate premium is reasonably estimable, the estimated ultimate premium shall be recognized as revenue over the period of the contract. Retrospective premiums should be estimated at the beginning of the plan year based upon actuarially determined models, and adjustments should be made based upon revisions to those estimates in each reporting period. Retrospective premium adjustments estimated for the portion of the policy period that has expired shall be considered and immediately recorded as an adjustment to premium. Paragraph 14 of FASB Statement No. 60 also requires that if the ultimate premium cannot be reasonably estimated, the cost recovery method or deposit method may be used until the ultimate premium can be reasonably estimated.

Either method will yield the same result for an annual period of a calendar-year financial reporting enterprise because the Medicare Part D programs are annual contracts for calendar-year periods. The two methods differ in the determination of a payable or receivable balance at the end of interim reporting periods.

The auditor should consider if a policy decision has been made about which model to follow for allocating the impacts of the risk-sharing provision between interim periods and if the accounting policy has been applied for similar contracts with mandatory experience rating provisions.

SAP. The NAIC Emerging Accounting Issues Working Group adopted Interpretation 05-05, *Accounting for Revenues Under Medicare Part D Coverage,* at its national meeting in December 2005. This Interpretation provides guidance to life and health insurers on how to present various funds to be received under the Medicare Part D Program. Interpretation 05-05 requires the application of existing SAP (SSAP No. 47, *Uninsured Plans;* SSAP No. 66, *Retrospectively Rated Contracts;* and SSAP No. 54, *Individual and Group Accident and Health Contracts,* depending upon the nature of the funds received).

Terrorism Insurance Developments

The market for terrorism risk insurance was severely disrupted by the events of September 11, 2001. Those events resulted in reinsurers choosing to no longer cover terrorism risk or to offer coverage only at very high rates. On November 26, 2002, the president signed TRIA into law. TRIA, which became effective immediately, established a temporary federal program of shared public and private compensation for insured commercial property and casualty losses resulting from acts of terrorism.

Accordingly, terrorism exclusions on existing insurance policies were removed, and all policyholders had the ability to secure coverage for terrorism risk through mandatory offer requirements placed on insurers. TRIA placed the federal government temporarily in the terrorism risk reinsurance business because the program was written to sunset on December 31, 2005. However, the Terrorism Risk Insurance Extension Act of 2005 (Amendments) was signed into law on December 22, 2005. The Amendments extend the Terrorism Risk Insurance Program (TRIP), established by TRIA, through December 31, 2007. Additionally, the Amendments further limit the lines of business that can participate in the TRIP, adding to existing exclusions (medical malpractice, reinsurance, life and health, crop, financial guaranty, and flood) the following lines: commercial auto, burglary and theft, surety, professional liability (as distinguished from directors and officers liability coverage), and farm owners multiple peril coverages. Thus, these lines are no longer required to participate in TRIP.

Under the original program, once an insurer has suffered a loss equal to its deductible, the U.S. Treasury will cover 90 percent of the losses above the deductible. The insurer's deductible increases over the life of the program. In 2004, the deductible was equal to 10 percent and increased to 15 percent of direct earned premium in 2005. TRIA also provides the U.S. Treasury with the authority to recoup federal payments via policyholder surcharges. The maximum amount of any potential policyholder surcharge that can be imposed is three percent per year. A summary of the major changes as a result of the Amendments is as follows:

- The Amendments increase the insurer deductible for the 2006 program year to 17.5 percent of the prior calendar year direct earned premiums; for the 2007 program year, the deductible increases to 20 percent of the prior calendar year direct earned premiums (the insurer deductible for the 2005 program year was 15 percent of the prior program year's direct earned premium).

- The Amendments increase the industry aggregate retention amount for 2006 and 2007 program years to: the lesser of $25 billion and the aggregate amount of insured losses for all insurers for the 2006 program year, and the lesser of $27.5 billion and the aggregate amount of insured losses for all insurers for the 2007 program year (the industry aggregate retention for the 2005 program year was $15 billion).

- For the 2006 program year, the Amendments establish a program trigger of $50 million in aggregate industry insured losses resulting from certified acts occurring after March 31, 2006. For the 2007 program year, the Amendments establish a program trigger of $100 million in aggregate industry insured losses resulting from certified acts occurring during the 2007 program year.

- Subject to the new program trigger, the Amendments maintain the federal share of compensation under the program at 90 percent of the portion of the amount of insured losses exceeding the applicable deductible for the 2006 program year, while reducing the federal share to 85 percent of the portion of the amount of insured losses exceeding the applicable deductible for the 2007 program year.

- The 2005 Amendments maintain the annual cap on insured losses at $100 billion for both the 2006 and 2007 program years.

Auditors may need to remain alert to developments in this area and, depending on what laws are in place, assess effects to disclosures, liability accruals, and subsequent events for 2006 fiscal year ends. The concern is that, in the absence of TRIA, it is likely that terrorism exclusions will again become the norm for commercial line policies and that private reinsurers are not likely to fill the reinsurance capacity void if TRIA expires after December 31, 2007.

The NAIC members have adopted a model bulletin to provide guidance to insurers related to rate filings and policy language that state regulators would find acceptable to protect U.S. businesses from acts of terrorism. They have also developed Model Disclosure Forms 1 and 2 to assist insurers in complying with TRIA. The model disclosure forms may be used and modified by insurers to meet their obligation under the rules, provide policyholders with the status of current coverage, and, in some cases, make a selection regarding future insurance coverage for acts of terrorism. Insurers must comply with state law and TRIA and are encouraged to review the disclosure forms in light of their current policy language, state legal requirements, and the provisions of the TRIA Amendments and TRIP.

Reminder—Consideration of the Examiners Handbook

The Model Audit Rule states that auditors shall consider the procedures in the NAIC *Financial Condition Examiners Handbook* (Examiners Handbook) in the conduct of the audit as the independent certified public accountant deems necessary. Although the AICPA supports increased communication with regulators and a better understanding of the financial examination process and procedures, it does not require auditors to perform procedures from the Examiners Handbook that they would not have otherwise performed as part of a generally accepted auditing standards (GAAS) audit. This revision of the Model Audit Rule places emphasis on giving consideration to the procedures contained in the Examiners Handbook. In planning the audit, auditors may consider incorporating into their planning documentation that they have given consideration to the Examiners Handbook procedures as they deemed necessary. In the conduct of financial examinations, examiners review, use, and rely upon the audit working papers.

Internal Control Issues and Developments

Enterprise Risk Management

Enterprise risk management (ERM) continues to be a topic of interest among insurance company management and rating agencies. ERM is an extension of risk-based capital concepts and includes all aspects of business operations that involve risk—insurance risk, investment risk, and operating and financial risk. In recent years, rating agencies began to encourage insurers to adopt advanced risk management practices and expressed their intent to evaluate the processes and techniques by which companies manage risk exposure as an integral part of their qualitative review of the company's business practices. In October 2005, Standard & Poor's (S&P) announced it would begin specifically analyzing insurers' ERM capabilities and consider those results when assigning ratings. S&P provided evaluation components to be analyzed and refined its ERM quality definitions in June 2006. Since S&P's actions, other rating agencies have commented on their position and views of ERM and how their ratings process already does or will include an assessment of advanced risk management practices. As the implementation of ERM evolves at insurance companies, related rating criteria are likely to change also.

Committee of Sponsoring Organizations of the Treadway Commission Internal Control and ERM Frameworks

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed a model for evaluating internal controls titled *Internal Control—Integrated Framework* (COSO Framework). More recently, passage of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and the subsequent establishment of the PCAOB have continued the relevance of the COSO Framework because it broadly serves as the accepted method for management to maintain systems of internal control. In September 2004, COSO issued *Enterprise Risk Management—Integrated Framework.* This framework expands on internal control, providing a more comprehensive focus on the broader subject of ERM. Although it does not replace the COSO Framework (though it does encompass it), organizations can use this ERM framework both to satisfy their internal control needs and to move toward a more complete risk management process. Among other aspects, the auditor may want to be familiar with the framework paradigm, which consists of four objectives (strategic, operations, reporting, and compliance) superimposed over eight components: (1) internal environment, (2) objective setting, (3) event identification, (4) risk assessment, (5) risk response, (6) control activities, (7) information and communication, and (8) monitoring.[5]

New Internal Control Guidance for Smaller Public Companies

As a result of the enactment of Sarbanes-Oxley, public companies and other organizations were prompted to turn their attention to evaluating internal control over financial reporting. Many smaller public companies found they needed assistance in applying the concepts of the COSO Framework, and COSO responded by initiating a project in January 2005 to assist smaller companies in implementing the COSO Framework.

The new guidance, released July 11, 2006, is titled *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies.* The objective of this guidance is to help smaller public companies and their auditors apply the COSO Framework in connection with assessing and reporting on the effectiveness of internal control over financial reporting. This new guidance consists of three volumes:

1. The executive summary volume provides a high-level summary for boards of directors and senior management.

5. Paragraph 25 of AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), requires that, in all audits, the independent accountant obtain an understanding of each of the five components of internal control (the control environment, risk assessment, control activities, information and communication, and monitoring) sufficient to plan the audit.

2. The fundamental principles and examples volume includes an overview of internal control over financial reporting in smaller companies; 20 fundamental principles drawn from the COSO framework, along with related attributes (characteristics associated with and supporting a principle) and approaches (describing how smaller companies can apply a principle); and examples of how smaller companies can apply the principles cost-effectively.
3. The tools volume contains illustrative tools, including templates, to help management evaluate internal control and determine whether the company has effectively applied the principles. This third volume may provide smaller companies with some additional ideas about how controls can be effectively documented.

Although the guidance was drafted for use by smaller public companies, the principles are equally applicable to large and small nonpublic companies, governmental agencies, and not-for-profit organizations. COSO recognizes that methods for applying the COSO Framework can and should differ for smaller businesses and identified the following themes for specific attention by smaller companies:

- The *control environment* is very important and sets the tone for internal control in a company. In smaller companies, the actions of management and its demonstrated commitment to effective governance and internal control are often more transparent than they are in larger companies.
- In identifying necessary controls, a company should consider the *risks* to reliable financial reporting and then identify controls required to mitigate those risks. Rather than focusing on mandating specific controls, the focus should be on linking those risks to the financial statement assertions and account balances that might be affected.
- *Control activities* require some minimum level of formalization. This is necessary so that everyone understands

their responsibilities, how the controls operate, and the importance of the control process.

- *IT* can enable effective internal control. Although IT often has been cited as a source of control risk, small companies can take advantage of IT to promote more effective control.

- *Monitoring* the effectiveness of internal control can take place in many different forms in smaller companies. This includes the ongoing monitoring that may already be in place, including monitoring by executives who have direct and explicit knowledge of the activities of the business. Management often relies on these controls in smaller companies.

- Employees should understand the risks, objectives, and their *personal responsibility for controls.* Even smaller companies can implement effective procedures so that when employees note control problems or deviations from acceptable practices, they can report these findings to the appropriate person before the problems or deviations become significant issues for the company.

A free copy of the executive summary of *Internal Control Over Financial Reporting—Guidance for Smaller Public Companies,* which contains the 20 fundamental principles mentioned previously, can be downloaded from www.coso.org/publications.htm.

COSO Request for Proposal on Monitoring Procedures

On October 17, 2006, COSO issued a request for proposal to develop guidance on the monitoring component of the COSO Framework. The project is scheduled to be completed by the end of 2007. The guidance is expected to describe the objectives of the monitoring component of the internal control framework, provide guidance on how ongoing and separate monitoring can meet the needs of Sarbanes-Oxley compliance, include cost-effective examples of monitoring activities for large and small companies, and provide monitoring tools and techniques to assist companies in their evaluation and assessment. For more information on the request for proposal, please visit www.coso.org.

SEC and PCAOB Update

Auditors may access the *SEC and PCAOB Alert—2006/07* (product no. 022497kk) for more comprehensive coverage of recent developments at the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

SEC Proposed Guidance on Internal Control Over Financial Reporting

During May 2006, the SEC announced a number of steps it would be taking to improve implementation of the internal control requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404). These steps included issuing interpretive guidance to assist management and working with the PCAOB to revise and approve pertinent issues within Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*).

Subsequently, on December 13, 2006, the SEC held an open meeting in which it voted to propose for public comment interpretive guidance for management regarding the evaluation of internal control over financial reporting. The guidance was released on December 20, 2006, as proposed rule Release No. 33-8762 and can be accessed at www.sec.gov/rules/proposed/2006/33-8762.pdf. The proposal is clear that companies evaluating internal controls in accordance with this new guidance would satisfy the Sarbanes-Oxley annual evaluation requirement. The proposed guidance intends to assist management in planning and performing its annual evaluation of internal control over financial reporting and reduce unnecessary costs and burdens while still maintaining the benefits of Section 404. The guidance is principle based. The two overarching principles are that:

1. Management should evaluate the design of implemented controls to determine whether they adequately address the

risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner.

2. Management should gather and analyze evidence about the operation of its controls based on its assessment of the risk associated with those controls.

The proposed guidance sets forth an approach by which management can perform a top-down, risk-based evaluation of internal control over financial reporting and is designed to be scaleable to allow smaller companies to tailor their evaluations of internal control to fit their size and complexity. Until this point, management has relied extensively on the standards written for auditors in implementing Section 404. The proposed rule also proposed amendments to Rule 2-02(f) of Regulation S-X to require only one opinion on the effectiveness of internal control over financial reporting. The auditor's attestation of management's evaluation required under Section 404(b) of the Sarbanes-Oxley Act would be subsumed within the auditor's opinion on the effectiveness of the company's internal controls. The proposed rule is open for public comment until February 27, 2007.

Further Relief from Section 404 Requirements for Smaller and Newly Public Companies

On December 15, 2006, the SEC adopted an extension of Section 404 compliance dates for nonaccelerated filers. Nonaccelerated filers were scheduled to begin including both management's assessment and an auditor's attestation to management's assessment on the effectiveness of internal control over financial reporting in their annual reports for fiscal years ending on or after July 15, 2007. Nonaccelerated filers will now provide management's report on internal control over financial reporting in its annual reports for fiscal years ending on or after December 15, 2007, and are not required to file the auditor's attestation report until filing an annual report for fiscal years ending on or after December 15, 2008. Management's report included in a nonaccelerated filer's annual report during the filer's first year of compliance with the Section 404(a) requirements will be considered *furnished* rather than filed.

Relief was also provided to newly public companies. A company will not become subject to the internal control over financial reporting requirements until it either has been required to file an annual report for the prior fiscal year with the SEC or had filed an annual report with the SEC for the prior fiscal year. The transition period intends to allow newly public companies to focus on their initial securities offerings and prepare for their first annual report without the additional burden of Section 404 compliance. The SEC press release and final rule (Release No. 33-8760) can be accessed at www.sec.gov/news/press/2006/2006-210.htm. The following table is included in the SEC press release and summarizes the revised compliance dates.

	Accelerated Filer Status[6]	*Revised Compliance Dates and Final Rules Regarding the Internal Control Over Financial Reporting Requirements*	
		Management's Report	*Auditor's Attestation*
U.S. Issuer	Large Accelerated Filer OR Accelerated Filer	Already complying (annual reports for fiscal years ending on or after November 15, 2004)	Already complying (annual reports for fiscal years ending on or after November 15, 2004)
	Nonaccelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
Foreign Issuer	Large Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
	Accelerated Filer	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Nonaccelerated Filer	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
U.S. or Foreign Issuer	Newly Public Company	Second Annual Report	Second Annual Report

6. Effective December 27, 2005, the SEC created a new category of companies called *large accelerated filers* and adjusted the definition of *accelerated filers*. A company is now

PCAOB

On December 19, 2006, the PCAOB held an open meeting where it voted unanimously to propose for public comment the following:

- Proposed auditing standard *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* to supersede the current Auditing Standard No. 2
- Proposed auditing standard *Considering and Using the Work of Others in an Audit* to replace current interim standards in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*) and the direction within Auditing Standard No. 2 relating to using the work of others
- Proposed Independence Rule 3525 *Audit Committee Preapproval of Services Related to Internal Control Over Financial Reporting*
- Proposed amendments to PCAOB Interim Standards

The proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* is written to be much shorter and easier to read than Auditing Standard No. 2; however, it does not diminish any of the existing principles in Auditing Standard No. 2. Provisions of the new standard emphasize the importance of risk assessment and direct auditors to focus on the most important controls (controls with the greatest potential to prevent or

an accelerated filer if its aggregate worldwide market value of voting and nonvoting common equity held by nonaffiliates is $75 million or more but less than $700 million and, as of the last business day of its most recently completed second fiscal quarter and the company has been subject to the reporting requirements of the Securities Exchange Act of 1934 for at least 12 calendar months, has filed at least one annual report, and is not a small-business issuer. A company is a large accelerated filer if it meets the last three aforementioned requirements and has an aggregate worldwide market value of voting and nonvoting common equity held by nonaffiliates of $700 million or more as of the last business day of the issuer's most recently completed second fiscal quarter. A nonaccelerated filer does not meet aforementioned Exchange Act Rule 12-b-2 requirements for accelerated or large accelerated filers and is therefore not required to file its annual and quarterly reports on an accelerated basis.

detect material misstatements). The proposed standard, among other things, removes the requirement to evaluate management's assessment process; clarifies the role of materiality (including interim materiality) in the audit; directs the auditor to tailor the audit for smaller and less complex companies; recalibrates walkthrough requirements; and revises the definitions of significant deficiency, material weakness, and strong indicators of material weakness.

The proposed auditing standard, *Considering and Using the Work of Others in an Audit,* allows the auditor to use the work of others for both the internal control and financial statement audits, eliminating barriers to the integration of the two audits. The proposed standard provides a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested. The principal evidence provision previously included in Auditing Standard No. 2 is eliminated in this proposed standard.

Auditors can access the complete PCAOB press release, briefing paper, proposed standards, and statements on the PCAOB Web site at www.pcaob.org/Rules/Docket_021/index.aspx. Public comments are due by February 26, 2007.

The NAIC's Sarbanes-Oxley Initiative Update

During the fall 2006 meeting, the NAIC adopted changes to the Model Audit Rule related to Sarbanes-Oxley, with the majority of those changes being effective for 2010. Beginning in 2003, the NAIC had been reviewing the requirements of Sarbanes-Oxley and formed several subgroups to carefully consider incorporating certain aspects of Sarbanes-Oxley into the Model Audit Rule. Sarbanes-Oxley consists of 11 titles; the key titles of interest to the NAIC have been Titles II, III, and IV. These titles relate to auditor independence (Title II), corporate responsibility (including audit committees) (Title III), and enhanced financial disclosures (Title IV). Enhanced financial disclosures include management's assertion relative to the effectiveness of its internal control over financial reporting and the auditor's attestation report on management's assertion.

Significant changes made to the Model Audit Rule related to Sarbanes-Oxley include:

- Section 7: The time allowed to serve in the capacity as the lead or coordinating audit partner was decreased from seven to five consecutive years with a new five year break in service (previously two years), effective beginning with year 2010 statutory audits.
- Section 7: There is a list of non-audit services that cannot be performed by the auditor in conjunction with the audit (the prohibitions generally agree with those designated by the SEC) effective for year 2010 statutory audits.
- Section 11: Auditors should prepare a written report communication of any unremediated material weaknesses that the insurer will furnish the domiciliary commissioner, effective beginning with year 2010 statutory audits. The current Model Audit Rule requires the auditor to prepare a report of significant deficiencies and material weaknesses in the insurer's internal control structure noted by the auditor during the audit. The AICPA NAIC Task Force has, for several years, undertaken efforts to confirm that states will accept the reporting of only those significant deficiencies and material weaknesses that are unremediated as of the balance sheet date, and it will continue to do so until the year 2010 effective date of the revised Model Audit Rule. For more information, see the section of this Alert titled "Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators."
- Section 14: There are new specifications for the responsibilities of audit committees and the required qualifications of audit committee members, effective January 1, 2010. The premium threshold that triggers the requirement for independent audit committee members is $300 million assumed and direct premiums. The premium range for a ma-

jority of independent audit committee members is $300 to $500 million. The requirement for a supermajority of independent audit committee members is $500 million in premiums.

- Section 16: Regarding Management's Report of Internal Control Over Financial Reporting, every insurer is required to file an audited financial report that has annual direct written and assumed premiums of $500 million or more shall prepare a report of the insurers' or group of insurers' internal control over financial reporting and file it with the Commissioner, effective December 31, 2010. The Model Audit Rule also includes a list of what should be included in Management's Report of Internal Control Over Financial Reporting. This report is prepared by management and is not audited.

At the September 2006 meeting, the NAIC adopted an Implementation Guide that was developed to assist insurers, auditors, and regulators in implementing the changes to the Model Audit Rule related to Sarbanes-Oxley. Auditors and preparers may want to be familiar with the Implementation Guide because it is a good supplement to the Model Audit Rule and provides interpretive guidance and clarifications of the terms used. The Implementation Guide will be maintained as a new appendix to the NAIC Manual.

Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators[7]

In May 2006, the AICPA Auditing Standards Board (ASB) issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*,

7. This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards,* vol. 1.) Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs. If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be

vol. 1, AU sec. 325), which supersedes SAS No. 60. This SAS is effective for audits of financial statements for periods ending on or after December 15, 2006. SAS No. 112 requires the auditor to evaluate identified control deficiencies and determine if they individually or when combined are significant deficiencies or material weaknesses. These terms are defined consistent with PCAOB Auditing Standard No. 2. The term *reportable condition* is no longer used. The SAS also requires that these communications now be in writing. The language definitions of significant deficiencies or material weaknesses in internal control have been referenced to SAS No. 112 in Section 11 of the revised Model Audit Rule; however, the change will not take place until the revisions to the Model Audit Rule are effective in 2010. As a result, the AICPA issued A Statutory Framework for Reporting Significant Deficiencies and Material Weaknesses in Internal Control to Insurance Regulators (Statutory Framework). The Statutory Framework was developed by members of the AICPA NAIC Task Force and AICPA staff and outlines a suggested framework for auditors to follow when reporting internal control deficiencies related to financial reporting identified during the course of an annual audit of statutory financial statements in accordance with SAS No. 112. For purposes other than satisfying Section 11 of the Model Audit Rule, the auditor also has to consider any additional reporting requirements of SAS No. 112 and SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380A)[8]. Even when no significant deficiencies or material weaknesses are identified, several states[9] (Florida, Idaho, Illinois, Maine, New York, North Carolina, Puerto Rico, and Vermont captive insurers) have a requirement that a letter be filed stating no material weaknesses have been identified.

appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

8. As mentioned, previously, SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards,* vol. 1, AU sec. 380), supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380A), and is effective for audits of financial statements for periods beginning on or after December 15, 2006.

9. For purposes of this framework, the term *states* includes other jurisdictions that are members of the NAIC.

Section 11 of the Model Audit Rule requires that, in addition to the annual audited financial statements, each insurer provide the Insurance Department with a written report prepared by the accountant describing significant deficiencies in the insurer's internal control structure noted by the accountant during the audit. While the current Model Audit Rule still specifically references SAS No. 60, auditors must follow SAS No. 112, when effective, for definitions and guidance on the reporting requirements. If significant deficiencies are noted, the written report should be filed annually by the insurer with the Insurance Department generally within 60 days following the filing of the annual audited financial statements. The insurer is required to provide a description of remedial actions taken or proposed to correct significant deficiencies if the actions are not described in the auditor's report.[10] The Statutory Framework can be accessed on the AICPA's Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/.

Year-End Auditing Considerations

For year-end 2006 reporting, the AICPA NAIC Task Force will again undertake efforts to determine whether individual states will again accept reporting of only those significant deficiencies and material weaknesses related to statutory-basis financial reporting of which the auditor becomes aware during the course of the audit that are unremediated as of the balance sheet date as being in compliance with the requirements of Section 11 of the Model Audit Rule. The AICPA NAIC Task Force will continue this effort until the revised Model Audit Rule is effective in 2010. Updated information on the confirmation process will be available from Kim Kushmerick at the AICPA (kkushmerick@aicpa.org).

10. State laws may vary, and thus it is necessary that companies and their auditors verify reporting requirements by reference to domiciliary state laws and regulations. For example, some states require the filing of the SAS No. 60 report at the same time the audited financial statements are filed.

Audit and Accounting Issues and Developments

Reinsurance Arrangements

During the past several years, the New York Attorney General's office, the SEC, several state insurance departments, and other governmental and regulatory bodies have been investigating the use of finite risk reinsurance contracts[11] and whether companies have properly accounted for these products. Several companies have restated previously issued financial statements to change their accounting for reinsurance arrangements, and some insurance company executives have been indicted or are the subject of enforcement actions. Reinsurance accounting and reporting—in particular, the question of what constitutes an acceptable transfer of risk and whether side agreements having accounting consequences exist between ceding and assuming companies—continue to be important issues requiring careful analysis.

FASB Statement No. 113 and EITF Topic No. D-34, "Accounting for Reinsurance: Questions and Answers about FASB Statement No. 113," continue to be the primary sources of guidance used to determine whether a contract transfers risk and meets the conditions for reinsurance accounting. In May 2006, the FASB issued an invitation to comment on "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting" (applies to policyholders, insurers, and reinsurers), with a comment deadline of August 2006. The invitation to comment asked for comments from buyers and sellers of insurance and reinsurance contracts and the users of their financial statements about the possible bi-

11. Finite or financial reinsurance contracts limit the risk (and rewards) of the underlying business transferred from the ceding company to the reinsurer, often through adjustable features within the reinsurance contract that alter the cash flows between the parties based on the level of losses ceded. Although finite reinsurance may restrict the amount of insurance risk transferred to the assuming company, the contract must still transfer significant insurance risk as defined by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts,* and the reinsurer must still be exposed to a reasonable possibility of a significant loss if the contract is to qualify for reinsurance accounting. By transferring less risk to the reinsurer, the insurer receives coverage on potential claims at a lower cost than traditional reinsurance. Due to the highly complex structure of these limited risk agreements, there can be abuses where no risk is transferred (such as a disguised loan), and the auditor should be alert to such agreements.

furcation of those contracts. At its December 6, 2006, meeting, the FASB decided that it would no longer pursue the issue of bifurcation of insurance and reinsurance contracts for financial reporting as part of its discussions relating to its insurance risk transfer project. The FASB decided the risk transfer project should focus on developing enhanced insurance and reinsurance disclosures that highlight any risk-limiting features included in those contracts, and to also work on developing additional language around the current FASB Statement No. 113 guidance to increase the level of risk transfer required for a contract to be accounted for as insurance. Information on the status of this project can be found on the FASB's Web site at www.fasb.org/project/insurance_risk_transfer.shtml.

The AICPA Insurance Expert Panel drafted a white paper that was sent to the FASB in November 2003 identifying certain risk transfer issues with respect to the application of risk transfer tests to certain contracts and differing interpretations as to the scope of the FASB Statement No. 113, paragraph 11, exception to the requirement that contracts accounted for as reinsurance expose the reinsurer to a reasonable possibility of significant loss. The white paper outlines issues identified in practice with possible responses, but does not include recommendations. It is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_insurance.htm. The AICPA reiterated the issues in the white paper in their comment letter in response to the FASB invitation to comment on "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting."

EITF Issue No. 93-6, EITF Issue No. 93-14, and EITF Topic No. D-35 represent guidance on required accruals when future rights and obligations under a multiple-year contract change based on loss experience to date.

SOP 98-7, *Deposit Accounting: Accounting for Insurance and Reinsurance Contracts That Do Not Transfer Insurance Risk,* should be used to determine the appropriate method of accounting for contracts that do not meet the requirements for reinsurance accounting under FASB Statement No. 113. SOP 98-7 outlines the appropriate accounting for contracts based on whether the contract transfers:

- Only significant timing risk
- Only significant underwriting risk
- Neither significant timing nor underwriting risk
- An indeterminate risk

Other accounting standards continue to have implications for transactions involving reinsurance arrangements. For example, FASB Interpretation No. 46, *Consolidation of Variable Interest Entities—an interpretation of ARB No. 51,* may necessitate counterparties to reinsurance arrangements placed in certain kinds of structures or entities (for example, catastrophe bond structures) to consider consolidation of these structures or entities. In addition, certain reinsurance contracts may contain embedded derivatives that require accounting in accordance with FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities.* Auditors may want to review FASB Statement No. 133 Implementation Issue No. B36, *Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments,* which addresses embedded derivatives in modified coinsurance and coinsurance with funds-withheld arrangements and other contracts with similar provisions where, for example, a return under the contract is calculated based on a referenced pool of assets. This implementation issue, which was last updated in June 2006, can be accessed on the FASB Web site at www.fasb.org/derivatives/issuindex.shtml.

As products become more advanced and complex, careful consideration is required to determine whether the contracts are being accounted for appropriately based on a complete understanding of the facts and circumstances. Alternative risk transfer products and finite risk covers usually present complex issues with respect to evaluating the contracts for risk transfer under FASB Statement No. 113. Auditors may need to assess whether companies have adequate internal controls to identify and analyze complex reinsurance agreements to determine the proper accounting.

Some Additional Auditing Considerations

Auditors of companies with significant reinsurance contracts also may consider directing procedures under AU section 316, *Consideration of Fraud in a Financial Statement Audit,* (AICPA, *Professional Standards,* vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*) toward these arrangements to identify any of the following:

- Contracts back-dated to avoid retroactive reinsurance accounting on coverage of losses that had already been incurred
- Side agreements to reimburse the reinsurer for covered losses or to return profits under a contract in a different accounting period
- *Linked* contracts where losses experienced under one will be reimbursed under another in the future and which should be considered together in the risk transfer analysis
- Contracts whose terms do not make economic sense and indicate a side agreement, or *linkage,* with another contract that should be considered in the accounting evaluation
- Exclusive reinsurance arrangements with offshore assuming companies that raise consolidation questions
- Commutations where the settlements are not in accordance with contract terms and suggest a noncontractual agreement on the allocation of profits and losses

Paragraph 02 of AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *Professional Standards,* vol. 1; and for audits conducted in accordance with PCAOB standards: AICPA, *PCAOB Standards and Related Rules*), states that an independent auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he is aware at the time. Are company disclosures with respect to significant reinsurance agreements in accordance with FASB Statement No. 113, and are disclosures with respect to ongoing regulatory investigations, if any, adequate?

New NAIC Reinsurance Disclosure and Filing Requirements

Reinsurance issues have taken center stage at the NAIC as regulators react to former New York State Attorney General's investigations of finite reinsurance, as well as allegations that undisclosed side agreements between ceding and assuming companies contributed to some property-casualty insolvencies. During 2005, the NAIC's SAP Working Group exposed updates to SSAP No. 62 that would expand disclosure requirements related to ceded reinsurance. These disclosures, which are also included as interrogatories in the annual statement, require detailed information about specific ceded reinsurance contracts.

The new disclosures were included in response to interrogatories in the 2005 annual statement filings. During 2006, the reinsurance interrogatory requirement was further amended by limiting the reinsurance contracts to be included in this interrogatory to those contracts having an underwriting effect, written premium ceded, or loss and loss expense reserves ceded greater than five percent of the prior year surplus, effective for 2007. The current limitation of three percent of surplus remains in effect for 2006 reporting. Beginning in 2006, these new reinsurance interrogatories are required to be included as accompanying supplemental schedules to the annual audited financial statements of insurance companies. As discussed briefly in this Alert, during the 2006 winter NAIC meeting, the SAP Working Group adopted this proposed change to narrow the scope of disclosure to reinsurance contracts entered into, renewed, or amended on or after January 1, 1994. The disclosures will be included in the 2006 audited financial statements for the first time. This limitation to post-1994 contracts does not apply to the disclosures in the annual statement interrogatories. The new financial statement disclosures include:

- Whether any quota share reinsurance contracts include provisions that would limit the reinsurer's losses below the stated quota share percentage (for example, a deductible, loss ratio corridor, loss cap, aggregate limits, or similar provisions). If such contracts exist, management is required to disclose whether the limiting provisions have had an effect on ceded losses

- Whether any significant contracts contain any of six specific contractual features often associated with finite reinsurance arrangements[12]
- Whether there are any significant contracts with related parties, other than approved pooling arrangements
- Whether any contracts are accounted for as reinsurance under SAP and as deposits under GAAP, or vice versa, and if so, why

For contracts meeting the first three bulleted criteria, management is further required to disclose (1) a summary of the reinsurance contract terms, (2) a brief discussion of management's principal objectives in entering into the agreement, including the economic purpose to be achieved, and (3) the aggregate financial statement impact gross of all such ceded reinsurance contracts on the balance sheet and statement of income.

In addition to the expanded disclosures, the NAIC has adopted a supplemental filing requiring the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) to separately attest to the appropriateness of the accounting procedures applied to the company's ceded reinsurance arrangements. Supplement 20-1, "Reinsurance Attestation Supplement: Attestation of Chief Executive Officer and Chief Financial Officer Regarding Reinsurance Agreements," shall be filed by March 1 and requires the CEO and CFO to make representations related to:

- The existence of any side agreements

12. The six specific contractual features are (1) contact terms greater than two years when the contract is noncancelable by the reporting entity, (2) cancellation provisions that trigger an obligation on the reporting entity to enter into a new reinsurance agreement with the reinsurer, (3) aggregate stop loss reinsurance coverage, (4) an unconditional or unilateral right by either party to commute the treaty, (5) a provision permitting reporting or payment of losses less frequently than on a quarterly basis, and (6) any features designed to delay timely reimbursement to the ceding entity.

- Whether management has documented its risk transfer analysis and such documentation is available for review
- The company's compliance with SSAP No. 62
- Whether appropriate internal controls are in place to monitor reinsurance

SOP 05-1, Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts

Issued by the AICPA's Accounting Standards Executive Committee in September 2005, SOP 05-1, *Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection With Modifications or Exchanges of Insurance Contracts,* provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in FASB Statement No. 97.

SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights, or coverages that occurs by the exchange of a contract for a new contract or by amendment, endorsement, or rider to a contract, or by the election of a feature or coverage within a contract. Modifications that result from the election by the contract holder of a benefit, feature, right, or coverage that was within the original contract are not internal replacements subject to this guidance as long as all of the conditions listed in paragraph 9 of the SOP are met:

- The election is made in accordance with terms fixed or specified within narrow ranges in the original contract.
- The election of the benefit, feature, right, or coverage is not subject to any underwriting.
- The insurance enterprise cannot decline to provide coverage or adjust the pricing of the benefit, feature, right, or coverage.

- The benefit, feature, right, or coverage had been accounted for since the inception of the contract.

SOP 05-1 introduces the terms *integrated* and *nonintegrated contract features* and specifies that nonintegrated features do not change the base contract and are to be accounted for in a manner similar to a separately issued contract. Integrated features are evaluated in conjunction with the base contract.

Contract modifications that result in a replacement contract that is substantially unchanged from the replaced contract should be accounted for as a continuation of the replaced contract (that is, unamortized deferred acquisition costs and other balances associated with the replaced contract continue to be deferred and amortized or earned in connection with the replacement contract). A contract is substantially unchanged if all of the conditions in paragraph 15 of SOP 05-1 are met:

- The insured event, risk, or period of coverage of the contract has not changed (that is, there are no significant changes in the kind and degree of mortality risk, morbidity risk, or other insurance risk, if any).
- The nature of the investment return (for example whether determined based on formulae specified in the contract, pass through of actual performance, or at the discretion of the insurer), if any, has not changed between the insurance enterprise and the contract holder.
- No additional deposit, premium, or charge relating to the original benefit or coverage, in excess of amounts specified or allowed in the original contract, is required to effect the transaction; or if there is a reduction in the original benefit or coverage, there is a reduction in the deposit, premiums, or charges that is at least equal to the corresponding reduction in benefits or coverage.
- There is no net reduction in the contract holder's account value (or cash surrender value, if any) other than for distributions to the contract holder or designee or charges related to newly purchased benefits or coverages.

- There is no change in the participation or dividend features of the contract, if any.
- There is no change in the amortization method or revenue classification of the contract.

An internal replacement that is determined to result in a replacement contract that is substantially changed from the replaced contract should be accounted for as an extinguishment of the replaced contract. Unamortized deferred acquisition costs, unearned revenue liabilities, and deferred sales inducement assets associated with contracts that have substantially changed should not be deferred in connection with the replaced contract.

Unamortized deferred acquisition costs and the present value of future profits continue to be subject to premium deficiency testing in accordance with the provisions of FASB Statement No. 60.

The notes to the financial statements should describe the accounting policy applied to internal replacements, including whether the company has availed itself of the alternative application guidance outlined in paragraphs 18 and 19 of SOP 05-1 and, if so, for which kinds of internal replacement transactions. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006. Retrospective application of SOP 05-1 to previously issued financial statements is not permitted. Initial application of SOP 05-1 should be as of the beginning of an entity's fiscal year. Additionally, disclosure of the effect of the change on retained earnings as of the date of adoption is required. If the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose the fact that SOP 05-1 has been adopted and the effective date of adoption, and the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of SOP 05-1.

A number of questions have been raised by auditors and insurers regarding the implementation of SOP 05-1. As a result, a task force made up of members of the SOP 05-1 Task Force and the Insurance Expert Panel has been formed to review questions submitted and to determine whether interpretive guidance, in the form of TPAs, is warranted. The FASB held a public roundtable meeting on January 30, 2007, and decided not to delay the effective date of SOP 05-1. Therefore, SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006.

Security Valuation Developments

Under GAAP, paragraph 16 of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* states that individual securities classified as either available-for-sale or held-to-maturity must be assessed to determine whether a decline in fair value below the amortized cost basis is other than temporary. If such a decline is judged to be other than temporary, the cost basis of the individual security is written down to fair value as the new cost basis, with the amount of the writedown included in earnings (that is, accounted for as a realized loss). The new cost basis should not be changed for subsequent recoveries in fair value.

Additionally, for other-than-temporary impairment analysis conducted in periods beginning after December 15, 2005, FSP FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments,* nullifies the guidance in paragraphs 10 through 18 of the FASB precursor issuance EITF Issue No. 03-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments," carries forward EITF Issue No. 03-1 cost method and disclosure requirements; supersedes EITF Topic No. D-44, "Recognition of Other-Than-Temporary Impairment upon the Planned Sale of a Security Whose Cost Exceeds Fair Value;" and refers to existing other-than-temporary impairment guidance, including Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock,* and SAB No. 59, *Accounting for Noncurrent Marketable Equity Securities.* The FSP also amends FASB Statements No. 115 and No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations,* and APB Opinion No. 18.

Scope

In short, FSP FAS 115-1 and FAS 124-1 provides guidance on determining (1) when an investment is considered impaired, (2) whether that impairment is other than temporary, and (3) measurement and timing of an impairment loss. The guidance is applicable to debt and equity securities that are within the scope of FASB Statements No. 115 and No. 124 and securities excluded from those Statements and not accounted for under the equity method pursuant to APB Opinion No. 18 (for example, cost-method investments). As indicated in paragraph 127(b) of FASB Statement No. 115, insurance companies are required to report equity securities at fair value, even if they do not meet the scope criteria in paragraph 3 of FASB Statement No. 115. Therefore, the FSP also applies to all equity securities held by insurance companies. Additionally, the outside form of the investment determines the accounting. For example, an investment in mutual fund shares is equity, even if the mutual fund consists mostly of debt securities. Finally, investments that require bifurcation and separate accounting for host instruments under paragraph 12 of FASB Statement No. 133 are included.

Year-End Accounting and Auditing Issues

A significant amount of insurers' investment portfolios are invested in fixed-income investments. Accordingly, insurers are exposed to the potential for a decline in portfolio market value should long-term interest rates rise, leading to unrealized losses and potentially to surplus declines. With the Federal Reserve increasing the federal funds rates throughout 2005 and half of 2006 and energy price increases contributing to inflation worries, many institutional investors, including insurers, believe that long-term rates may be headed higher. All those in the insurance industry will be closely watching the movement of long-term rates in 2007.

Additionally, the interest rate increase is coupled with rising credit quality concerns surrounding certain asset-backed investments. The auditor can evaluate if management has considered the separate or combined effect of these market forces on a potential impairment. The situation could create a more complex auditing environment surrounding security valuation and potential impairment for 2006.

Accounting and Auditing Guidance

FASB Statement No. 115 should continue to be followed along with FSP FAS 115-1 and FAS 124-1. Note that FSP FAS 115-1 and FAS 124-1 provides impairment indicators that should be used in evaluating whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment. The auditor can evaluate if management has considered that the definition of *other-than-temporary* does not necessarily mean permanent. The FSP does not provide guidance on making an other-than-temporary assessment. Instead, one must apply other guidance such as in FASB Statement No. 115. Additionally, SEC SAB Topic 5M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities,* states that there are numerous factors to be considered when evaluating for other-than-temporary impairment. Factors include, but are not limited to, the length of time and extent to which the market value has been below cost and the intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. Another variable is the financial condition and near-term prospects of the issuer, which includes any specific events that may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment that could affect future earnings potential of the issuer. Other sources of guidance include paragraph 6 of APB Opinion No. 18 and EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets." The FASB special report, *A Guide to Implementation of Statement 115 on Accounting for Certain Investments in Debt and Equity Securities: Questions and Answers,* is also relevant.

FSP FAS 115-1 and FAS 124-1 states that in periods subsequent to the recognition of an other-than-temporary impairment loss for debt securities, an investor must account for the other-than-temporarily impaired debt security as if the debt security had been purchased on the measurement date of the other-than-temporary impairment. That is, the discount or reduced premium recorded for the debt security, based on the new cost basis, would be amortized over the remaining life of the debt security in a prospective manner based on the amount and timing of future estimated cash flows.

When an investor has decided to sell an impaired available-for-sale security and the investor does not expect the fair value of the security to fully recover prior to the expected time of sale, the security is deemed other-than-temporarily impaired in the period in which the decision to sell is made. However, an investor must recognize an impairment loss in the period the decision is made rather than when the actual sale occurs. This incorporates the concept from EITF Topic No. D-44. The aforementioned information does not preclude impairment evaluation of securities that are not planned on being held to recovery. Paragraph 14 of FSP FAS 115-1 and FAS 124-1 states that "an investor shall recognize an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made." For further information, see SEC SAB Topic 5M. Finally, FSP FAS 115-1 and FAS 124-1 states that for post-impairment income recognition, income must be recognized on expected, not contractual, cash flows.

Related auditing considerations include evaluation of management's current and former practices regarding FASB Statement No. 115 securities, accounting practice consistency among periods, and rationale for any practice changes in the areas surrounding FSP FAS 115-1 and FAS 124-1. The issue of tainting could occur under certain circumstances; for example, a pattern of selling securities that were intended to hold until recovery, or sales occurring soon after intent to hold decisions. Documentation continues to be paramount with regard to these issues. In December 2005, the ASB issued SAS No. 103, *Audit Documentation,* (AICPA, *Professional Standards,* vol. 1, AU sec. 339). This SAS supersedes SAS No. 96 of the same name and amends paragraphs .01 and .05 of SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 530). SAS No. 103 is effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. Public issuers can refer to Auditing Standard No. 3, *Audit Documentation* (AICPA, *PCAOB Standards and Related Rules*). Finally, unsubstantiated changes in management practice need to be carefully questioned for appropriateness under the aforementioned GAAP literature listed in this section.

Statutory Accounting

Under SAP, determining whether impairment has occurred on an investment under the NAIC Manual is similar to GAAP. Management needs to consider all available evidence in determining whether an impairment exists and if that impairment is other than temporary. For each type of investment, specific measurement criteria are set out in the SSAPs. Differences do arise between GAAP and SAP regarding the timing of an impairment loss for securities subject to EITF Issue No. 99-20. Additionally, under SAP, impairments related to interest rates or sector spreads are recorded when there is an intent to sell the related security.

The NAIC Manual requires that a loss be realized for other-than-temporary impairments of the value of investments. Significant judgment is involved in determining whether a decline in fair value is temporary or reflects conditions that are more persistent. Evidence should support management's assertion that a decline in fair value is only temporary. At the fall 2006 NAIC meeting, the Emerging Accounting Issues Working Group voted to adopt the disclosure requirements of FSP FAS 115-1 and FAS 124-1, effective for 2006. At that time, the Emerging Accounting Issues Working Group exposed an interpretation that incorporates portions of the FSP. During the winter NAIC meeting, the Emerging Accounting Issues Working Group confirmed its tentative consensus, with modifications, as final. The finalized interpretation, Interpretation 06-07, *Definition of Phrase 'Other Than Temporary',* incorporates portions of FSP FAS 115-1 and 124-1 (paragraphs 6, 7, and 11), rejects other concepts (paragraphs 1–5, 8–10, 12–15, and 19), and adopts certain aspects of the consensus reached in Interpretation 02-07, *Definition of Other Than Temporary.*

Quantifying Misstatements

On September 13, 2006, the SEC released SAB No. 108, Topic 1N, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.* Although the guidance is directed at registrants, it is also important for auditors as they consider and quantify the effects of misstatements in financial statements. The issuance provides interpretive guidance on how the effects of the carryover or reversal of prior year misstatements should be considered in quantifying a current year misstatement.

Two approaches have commonly been used to quantify such errors. Under one approach, the error is quantified as the amount by which the current year income statement is misstated (the rollover approach). The other common approach quantifies the error as the cumulative amount by which the current year balance sheet is misstated (the iron curtain approach). Exclusive reliance on an income statement approach can result in a registrant accumulating errors on the balance sheet that may not have been material to any individual income statement, but that nonetheless may misstate one or more balance sheet accounts. Similarly, exclusive reliance on a balance sheet approach can result in a registrant disregarding the effects of errors in the current year income statement that result from the correction of an error existing in previously issued financial statements.

The staff believes registrants must quantify the impact of correcting all misstatements, including both the carryover and reversing effects of prior year misstatements, on the current year financial statements. The SEC staff believes that this can be accomplished by quantifying errors under both a balance sheet and an income statement approach and by evaluating errors measured under each approach. Thus, a registrant's financial statements would require adjustment when either approach results in quantifying a material misstatement after considering all relevant quantitative and qualitative factors.

If, in correcting an error in the current year, an error is material to the current year's income statement, the prior year financial statements should be corrected, even though such a revision previously was and continues to be immaterial to the prior year financial statements. Correcting prior year financial statements for immaterial errors would not require previously filed reports to be amended. Such correction may be made the next time the registrant files the prior year financial statements. However, registrants electing not to restate prior periods should follow the disclosure requirements specified in the SAB. In general, SAB No. 108 is effective for financial statements for fiscal years ending after November 15, 2006, with earlier application encouraged in any report for an interim period of the first fiscal year ending after November 15, 2006, and filed after the SAB's publication date of September 13, 2006. For additional accounting and transition information, see the issuance at www.sec.gov/interps/account/sab108.pdf.

Auditors should be aware if their clients are following appropriate disclosure requirements under GAAP and SAP, respectively for any adjustments made as a result of SAB No. 108. Additionally, auditors should note the FASB has announced a project to address the process of quantifying misstatements in current year financial statements arising from the carryover or reversal of prior period errors for the purpose of evaluating materiality. At the time of this writing, the FASB is drafting a proposed FSP to address this issue. In response to SAB No. 108, changes may be made to the recently issued Risk Assessment Standards, which are discussed in the next section. Specifically, changes may be made to SAS No. 107, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 312).

FASB Statement No. 133 Implementation Guidance

The Derivatives Implementation Group helped the FASB staff answer significant questions that companies face when implementing FASB Statement No. 133.

The FASB staff has issued guidance on numerous FASB Statement No. 133 implementation issues, and this guidance can be obtained from the FASB Web site at www.fasb.org. Following is a listing of the insurance-product-related topics that were addressed, together with a brief discussion of the nature of each issue and the date of FASB clearance. This list is intended to highlight to auditors of insurance companies those areas where the application of FASB Statement No. 133 may be required. In addition to the issues listed below, several other FASB Statement No. 133 implementation issues are applicable to companies operating in all industries; such issues also may be relevant to an audit of an insurance company.

Topic	***Guidance***
A16—Definition of a Derivative: Synthetic Guaranteed Investment Contracts (March 14, 2001)	Synthetic guaranteed investment contracts meet the definition of *derivatives* in accordance with paragraph 6 of FASB Statement No. 133.
B7—Embedded Derivatives: Variable Annuity Products and Policyholder Ownership of Assets (revised September 25, 2000)	Traditional variable annuity products do not contain embedded derivatives that warrant separate accounting under FASB Statement No. 133, even though the insurer, rather than the policyholder, actually owns the assets.
B8—Embedded Derivatives: Identification of the Host Contract in a Nontraditional Variable Annuity Contract (revised September 25, 2000)	Nontraditional variable annuity contracts are distinguished from traditional variable annuity contracts by the fact that investment risk associated with the assets backing the nontraditional variable annuity contracts is shared between the issuer and the policyholder. The host contract for a nontraditional variable annuity contract is the traditional variable annuity portion of the contract (that is, without the nontraditional embedded components).
B9—Embedded Derivatives: Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options (December 6, 2000)	The economic characteristics and risks of the embedded derivative (market-adjusted value prepayment option) in a market value annuity contract are clearly and closely related to the economic characteristics and risks of the host contract and, therefore, need not be bifurcated in accordance with paragraph 12 of FASB Statement No. 133.

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Topic	*Guidance*
B10—Embedded Derivatives: Equity-Indexed Life Insurance Contracts (revised June 16, 2006)	The existence of a death benefit provision does not exclude the entire equity-indexed life insurance contract from being subject to FASB Statement No. 133 for either the issuer or the policyholder because the policyholder can obtain an equity-linked return by exercising the surrender option before death.
B25—Embedded Derivatives: Deferred Variable Annuity Contracts with Payment Alternatives at the end of the Accumulation Period (revised December 19, 2001)	Deferred variable annuity contracts may contain minimum benefit guarantees in either the accumulation or payout phases of the contract. This issue provides derivative accounting guidance for four separate minimum guarantee scenarios.
B26—Embedded Derivatives: Dual-Trigger Property and Casualty Insurance Contracts (March 14, 2001)	A property and casualty contract that provides for the payment of benefits and claims as a result of both an identifiable insurable event and changes in a variable would not contain an embedded derivative instrument that is required to be separately accounted for under FASB Statement No. 133 provided (1) benefits and claims are paid only if an identifiable insurable event occurs (for example, theft or fire), (2) the amount of the payment is limited to the amount of the policyholder's incurred insured loss, and (3) the loss is not virtually certain to occur.
B27—Embedded Derivatives: Dual-Trigger Financial Guarantee Contracts (revised March 26, 2003)	A financial guarantee insurance contract for which payment of a claim is triggered only by the occurrence of the insured's credit losses exceeding a specified level on its loans held (though the amount of the payment is affected by the credit losses in a customized pool of loans by third parties exceeding the same specified level) is an insurance contract that is not subject to FASB Statement No. 133 requirements because it indemnifies the insured for its actual losses incurred above a specified level. A provision limiting claims in the event the insured's credit losses exceed the credit losses in a referenced pool or index of consumer loans represents a type of deductible, rather than an embedded derivative that warrants separate accounting under FASB Statement No. 133.

Topic	*Guidance*
B28—Embedded Derivatives: Foreign Currency Elements of Insurance Contracts (revised March 26, 2003)	Contracts that pay claims in a currency different from the one in which the loss is measured at a predetermined contract exchange rate are not deemed to have an embedded foreign currency derivative.
B29—Embedded Derivatives: Equity-Indexed Annuity Contracts with Embedded Derivatives (revised June 16, 2006)	Equity-indexed annuities that contain *point-to-point* or *ratchet design* features qualify as contracts with embedded equity derivatives that must be bifurcated and reported at fair value in accordance with paragraph 12 of FASB Statement No. 133.
B30—Embedded Derivatives: Application of Statement 97 and Statement 133 to Equity-Indexed Annuity Contracts (revised June 16, 2006)	Equity-indexed annuities contain a debt instrument with an embedded (equity option) derivative. Upon receipt of the consideration for the equity-indexed contract, the issuer is required to allocate a portion of the consideration to the derivative and the remainder to a fixed annuity host contract. Interest credited and changes in the fair value of the derivative should be recognized in earnings. The host contract should be accreted to the minimum account value at the end of the contract using the effective yield method. A minimum liability shall not be recorded if, prior to the maturity of the contract, the aggregate of the host account value and the market value of the derivative is less than the value of the contract on a FASB Statement No. 97 basis (that is, without bifurcating the derivative).
B31—Embedded Derivatives: Accounting for Purchases of Life Insurance (revised March 27, 2006)	FASB Technical Bulletin No. 85-4 prescribes the accounting for life insurance contracts commonly referred to as COLI (corporate-owned life insurance), BOLI (business-owned life insurance), and key-man insurance. This accounting treatment is applicable even though these insurance contracts include derivative-like provisions that would otherwise require separate accounting as derivatives under paragraph 12 of FASB Statement No. 133.
B36—Embedded Derivatives: Modified Coinsurance Arrangements and Debt Instruments That Incorporate	An instrument that incorporates credit risk exposures that are either unrelated or only partially related to the creditworthiness of that instrument's obligor has an embedded

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Topic	*Guidance*
Credit Risk Exposures That Are Unrelated or Only Partially Related to the Creditworthiness of the Obligor under Those Instruments (revised June 16, 2006)	derivative that is not considered *clearly and closely related* to the economic characteristics and risks of the host contract. B36 affects the accounting for credit-linked notes that incorporate a third party's credit (or default) risk and modified coinsurance arrangements between reinsurers and ceding insurance companies and similar arrangements, which typically include a provision for passing a return that is linked to the performance of investments held by the ceding company to the reinsurer. The scope of B36 encompasses any receivable or payable where the interest is determined by reference to an actual pool of assets (unless the pool were comprised entirely of risk-free debt securities or real estate) or determined by any index other than a *pure* interest rate index.
C1—Scope Exceptions: Exception Related to Physical Variables (February 17, 1999)	If a contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of FASB Statement No. 133 because it would not meet the exclusion in paragraph 10(e)(1) of FASB Statement No. 133.
G4—Cash Flow Hedges: Hedging Voluntary Increases and Interest Credited on an Insurance Contract Liability (revised September 25, 2000)	FASB Statement No. 133 would permit an insurance company to qualify for cash-flow hedge accounting if it is hedging the possibility that it may need to voluntarily increase the interest rate used to credit interest on certain whole life, universal life, repetitive premium variable annuity, and single premium variable annuity contract liabilities. However, to qualify for cash-flow hedge accounting, changes in the hedged interest payments attributable to the hedged risk must be sufficiently correlated with the changes in the cash flows of the hedging derivative.

Reminder—Actuarial Data Integrity

The NAIC *Annual Statement Instructions: Property and Casualty* requires coordination among the auditor, the appointed actuary, and management and may potentially require additional procedures for the auditor related to claim loss and loss adjustment expense data. Section 9 of the instructions, "Scope of Examination and Report of Independent Certified Public Accountant," states:

> The insurer shall also require that the independent certified public accountant subject the data used by the appointed actuary to testing procedures. The auditor is required to determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of loss data and perform testing as (to) the understanding of the controls related to the completeness, accuracy, and classification of loss data, and perform (other) testing (as) the auditor deems appropriate. Through inquiry of the appointed actuary, the auditor should obtain an understanding of the data identified by the appointed actuary as significant. It is recognized that there will be instances when data identified by the appointed actuary as significant to his or her reserve projections would not otherwise have been tested as part of the audit, and separate testing would be required. Unless otherwise agreed among the appointed actuary, management and the auditor, the scope of the work performed by the auditor in testing the claims data in the course of the audit would be sufficient to determine whether the data tested is fairly stated in all material respects in relation to the statutory financial statements taken as a whole. The auditing procedures should be applied to the claim loss and defense and cost containment expense data used by the appointed actuary and would be applied to activity that occurred in the current calendar year (e.g., tests of payments on claims paid during the current calendar year).

There may be circumstances in which data deemed significant by the appointed actuary are not included as part of the statutory financial statement audit. This may result in a need for additional testing outside the scope of the statutory audit to comply with the NAIC data integrity requirements. The conclusion regarding the need for the auditor to perform additional procedures should be agreed with management, after discussion with the appointed actuary. Additional procedures needed to fulfill the NAIC requirement for data integrity could be accomplished through an Agreed-Upon Procedures report, performed in accordance with AICPA professional standards. In October 2004, the American Academy of Actuaries Committee on Property & Liability Financial Reporting published a paper on this area titled *Data Testing Requirement in 2004 P/C Annual Statement Instructions: Guidance For Actuaries Signing Statements of Actuarial Opinions on Loss and Loss Expense Reserves.* The paper can be found on the American Academy of Actuaries Web site at www.actuary.org.

Reminder—Access to CPA Audit Documentation

An external auditor is required by the NAIC Model Audit Rule to provide timely access to or copies of audit documentation when requested by regulators.

Interpretation No. 1, "Providing Access to or Copies of Audit Documentation to a Regulator," in AU section 9339, *Audit Documentation: Auditing Interpretations of Section 339* (AICPA, *Professional Standards,* vol. 1, AU sec. 9339.01–9339.15; AICPA, *PCAOB Standards and Related Rules,* AU sec. 9339.01–9339.15), addresses the responsibilities of an auditor when a regulator requests access to audit documentation. Auditors should note that PCAOB Auditing Standard No. 3, *Audit Documentation,* (AICPA, *PCAOB Standards and Related Rules*), supersedes AU section 339 (AICPA, *PCAOB Standards and Related Rules*) for audits of public companies and other issuers.

The AICPA's task force on NAIC matters has worked actively with subgroups consisting of designated regulators and NAIC representatives to pursue ways to increase the examiners' reliance upon the statutory audit and use of underlying audit documentation. Suggested protocols were forwarded to the Financial Examiners Handbook Technical Group for consideration of possible revisions to the Examiners Handbook and have been incorporated into the most recent version of the Handbook. Additionally, letters were sent to chief examiners in the states apprising them of the new process.

The AICPA NAIC Task Force helped to establish the four-step process to provide a protocol for financial examiners who are having difficulty pursuing a resolution of (1) questions with respect to a firm's individual engagement to perform a statutory audit, (2) difficulties in gaining access to working papers, or (3) the regulator concerns about the work performed by the CPA. If a financial examiner determines that an additional response is required, after informing appropriate management, the financial examiner would contact the following individuals in this suggested order, as needed:

1. The engagement partner
2. The designated national firm representative (included on the NAIC Web site)
3. Chair of the insurer's audit committee
4. State board of accountancy, ethics (or quality review) committee, or other regulatory bodies deemed appropriate

Firms or individual practitioners performing statutory audits of regulated insurance entities that wish to designate a national firm representative and have not already done so should contact NAIC representatives at (816) 783-8006 or (816) 783-8132.

Recent Auditing and Attestation Pronouncements and Related Guidance

Presented in the following table is a list of recent auditing and attestation pronouncements and related guidance. For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/. You may also look for announcements of newly issued standards in the *CPA Letter, Journal of Accountancy,* and in the quarterly electronic newsletter, *In*

Our Opinion, issued by the AICPA Auditing Standards team, available at www.aicpa.org.

The PCAOB establishes auditing and attestation standards for audits of public companies. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2006/07* (product no. 022497kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

Recent Auditing and Attestation Pronouncements and Related Guidance

SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards,* vol. 1, AU sec. 120) Statement on Standards for Attestation Engagements (SSAE) No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards,* vol. 1, AT sec. 20) Issue Date: December 2005 (Not applicable to audits conducted in accordance with PCAOB standards)	These standards established two categories of professional requirements that are identified by specific terms. The words *must* or *is required* are used to indicate an unconditional requirement. The word *should* is used to indicate a presumptively mandatory requirement. The words *may, might, could,* and *should consider* represent actions that auditors have a professional obligation to consider. The provisions of SAS No. 102 and SSAE No. 13 were effective upon issuance. It is the ASB's intention to make conforming changes to AICPA literature over the next several years to remove any language that would imply a professional requirement where none exists.
SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards,* vol. 1, AU sec. 339) Issue Date: December 2005 (Not applicable to audits conducted in accordance with PCAOB standards)	SAS No. 103 supersedes SAS No. 96, *Audit Documentation,* and amends SAS No. 1, section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards,* vol. 1, AU sec. 530). This standard is effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted. This SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation. See the "SAS No. 103, Audit Documentation" section in this Alert.

SASs No. 104 through No. 111, the Risk Assessment Standards Issue Date: March 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	See the "AICPA Risk Assessment Standards" section in this Alert.
SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 325) Issue Date: May 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	The new standard supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit.* It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.
SAS No. 113, *Omnibus Statement on Auditing Standards—2006* (AICPA, *Professional Standards,* vol. 1) Issue Date: November 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	This standard: • Revises the terminology used in the 10 standards of SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards,* vol. 1, AU sec. 150), to reflect terminology in SAS No. 102, *Defining Professional Requirements in Statements on Auditing Standards* (AICPA, *Professional Standards,* vol. 1, AU sec. 120); • Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards,* vol. 1, AU sec. 316) to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks; • Replaces throughout the SASs *completion of fieldwork* with the term *date of the auditor's report;* and

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	• Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report.
SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380) Issue Date: December 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	This standard replaces SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards,* vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit, and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication.
SSAE No. 14, *SSAE Hierarchy* (AICPA, *Professional Standards,* vol. 1, AT sec. 50) Issue Date: November 2006 (Not applicable to audits conducted in accordance with PCAOB standards)	This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attest engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, *Defining Professional Requirements in Statements on Standards for Attestation Engagements* (AICPA, *Professional Standards,* vol. 1, AT sec. 20).
AICPA TPA sections 8100.01–8100.02 (Nonauthoritative)	The title of section 8100.01 is "Determining the Effective Date of a New Statement on Auditing Standards for Audits of a Single Financial Statement," and the title of section 8100.02 is "Determining the Effective Date of a New Statement on Auditing Standards for Audits of Interim Periods."
PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* Issue Date: February 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This standard applies if auditors report on the elimination of a material weakness in a company's internal control over financial reporting. The standard establishes a voluntary engagement that would be performed at the election of the company.

PCAOB Conforming Amendment to AT 101.04f, *Attest Engagements, Conforming Amendment to PCAOB Auditing and Related Professional Practice Standards Resulting from the Adoption of the Auditing Standard No. 4* Issue Date: February 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The conforming amendment states that Auditing Standard No. 4 must be used for reporting on whether a material weakness continues to exist for any purpose other than a company's internal use.
PCAOB Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees Issue Date: April 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The rules include general rules with respect to ethics and independence, restrict certain types of tax services a registered public accounting firm may provide to its audit clients, and prohibit contingent fee arrangements for any services a registered public accounting firm provides to its audit clients in order to maintain its independence.
PCAOB Report on the Initial Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules,* PCAOB Staff Guidance sec. 300) Issue Date: November 2005 (Applicable to audits conducted in accordance with PCAOB standards only)	This report reaffirmed and amplified previous guidance issued by the PCAOB in May 2005. The report focuses on reasons the PCAOB found audits performed were not always as efficient and effective as Auditing Standard No. 2 intended. The report also explains certain aspects of Auditing Standard No. 2 such as the terms *more than remote* and *strong indicators.*
PCAOB Overview of Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist* Issue Date: April 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This overview provides additional information on the provisions of Auditing Standard No. 4.

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PCAOB Staff Questions and Answers, *Adjustments to Prior-Period Financial Statements Audited by a Predecessor Auditor* Issue Date: June 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The guidance explains that if prior period financial statements that require adjustments were audited by a predecessor auditor, either the successor auditor or the predecessor auditor may audit the adjustments as long as the auditor is independent and registered with the PCAOB. The guidance continues to address questions regarding when the predecessor auditor audits the prior period financial statement adjustments, when the successor auditor audits the prior period financial statement adjustments, and when the successor auditor has not yet completed an audit of the current period financial statements.
PCAOB Staff Audit Practice Alert No. 1, *Matters Relating to Timing and Accounting for Options Grants* Issue Date: July 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	This issuance was prompted by recent reports and disclosures about issuer practices related to the granting of stock options, including the *backdating* of such grants. The guidance identifies existing standards that could bear on auditors' work and applies them to the issues that have been raised regarding companies' stock option granting practices. It does not establish new requirements.
PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards only)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment,* which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

SAS No. 103, *Audit Documentation*

In December 2005, the ASB issued SAS No. 103, *Audit Documentation,* (AICPA, *Professional Standards,* vol. 1, AU sec. 339). This SAS supersedes SAS No. 96 of the same name. Effective for audits of financial statements for periods ending on or after December 15, 2006, with earlier application permitted, this SAS establishes standards and provides guidance to an auditor of a nonissuer on audit documentation.

The SAS also amends paragraphs .01 and .05 of SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards,* vol. 1, AU sec. 530, "Dating of the Independent Auditor's Report"), as amended. The amendment requires that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the company's financial statements, including disclosures, have been prepared and that management has asserted that they have taken responsibility for them. Consider how this guidance affects the process followed on your engagements (including the review of audit documentation and financial statements, obtaining management's representations, and analyzing subsequent events) and how this affects the date of the audit report.

AICPA Risk Assessment Standards

In March 2006, the AICPA ASB issued eight SASs that provide extensive guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit. The following table lists the eight SASs and their effects on existing standards.

Statement on Auditing Standard	***Effect on Existing Standards***
SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures (*"Due Professional Care in the Performance of Work"*)	This Statement amends SAS No. 1, *Due Professional Care in the Performance of Work* (AU section 230).

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Statement on Auditing Standard	*Effect on Existing Standards*
SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards	This Statement amends SAS No. 95, *Generally Accepted Auditing Standards* (AU section 150).
SAS No. 106, *Audit Evidence*	This Statement supersedes SAS No. 31, *Evidential Matter* (AU section 326A).
SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*	This Statement supersedes SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU section 312A).
SAS No. 108, *Planning and Supervision*	This Statement supersedes SAS No. 1, *Appointment of the Independent Auditor* (AU sec. 310) and supersedes SAS No. 22, *Planning and Supervision* (AU section 311A).
SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*	This Statement supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319).
SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*	This Statement supersedes SAS No. 45, *Substantive Tests Prior to the Balance Sheet Date* (AU section 313) and together with SAS No. 109, supersedes SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AU section 319).
SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling	This Statement amends SAS No. 39, *Audit Sampling* (AU section 350).

Key Provisions of the New Standards

The SASs emphasize the link between understanding the entity, assessing risks, and the design of further audit procedures. The SASs introduce the concept of risk assessment procedures, which are deemed necessary to provide a basis for assessing the risk of material misstatement. Risk assessment procedures, along with further audit procedures, which consist of tests of controls and substantive tests, provide the audit evidence to support the auditor's opinion of the financial statements. According to the SASs, the auditor should perform risk assessment procedures to gather information and gain an understanding of the entity and its environment, including its internal controls. These procedures include inquiries, analytical procedures, and inspection and observation. Assessed risks and the basis for those assessments should be documented; therefore, auditors may no longer default to maximum control risk for an entity's risk assessment without documenting the basis for that assessment. The SASs also require auditors to consider and document how the risk assessment at the financial statement level affects individual financial statement assertions, so that auditors may tailor the nature, timing, and extent of their audit procedures to be responsive to their risk assessment. It is anticipated that generic audit programs will not be appropriate for all audit engagements because risks vary among entities.

Effective Date and Implementation

The SASs are effective for audits of financial statements for periods beginning on or after December 15, 2006; earlier application is permitted. In most cases, implementation of the SASs will result in an overall increased work effort by the audit team, particularly in the year of implementation. It is also anticipated that to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. Readers can obtain the SASs and the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

New Companion Audit Guide

In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This Guide will help auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The Guide can be ordered by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com.

Recent Independence and Ethics Pronouncements

The AICPA *Independence and Ethics Alert—2006/2007* (product no. 022477kk) contains a complete update on new independence and ethics pronouncements. This Alert can be obtained by calling the AICPA at (888) 777-7077 or going online at www.cpa2biz.com. Readers should obtain this Alert to be aware of independence and ethics matters that will affect their practice.

The AICPA general *Audit Risk Alert—2006/07* (product no. 022337kk) and other AICPA industry-specific Alerts contain summaries of recent pronouncements not included here. To obtain copies of other AICPA Alerts, contact AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

Recent Accounting Pronouncements and Related Guidance

Presented in this section is a list of recent accounting pronouncements and related guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy.*

Recent Accounting Pronouncements and Related Guidance

FASB Statement No. 155	*Accounting for Certain Hybrid Financial Instruments—an amendment of FASB Statements No. 133 and 140*
FASB Statement No. 156	*Accounting for Servicing of Financial Assets—an amendment of FASB Statement No. 140*
FASB Statement No. 157	*Fair Value Measurements*
FASB Statement No. 158	*Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*

Recent Accounting Pronouncements and Related Guidance

FASB Interpretation No. 48	*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*
FSP FTB 85-4-1	*Accounting for Life Settlement Contracts by Third-Party Investors*
EITF Issue No. 06-4	"Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"
EITF Issue No. 06-5	"Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"
FASB EITF Issues	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FSPs	Go to www.fasb.org/fasb_staff_positions for a complete list of FSPs.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"
AICPA TPA sections 6910.21–6910.24 (Nonauthoritative)	These TPA sections discuss various investment company topics.
AICPA TPA section 5700.01 (Nonauthoritative)	"Income Tax Accounting for Contributions to Certain Nonprofit Scholarship Funding Organizations"
AICPA TPA section 2210.28 (Nonauthoritative)	"Accounting for Certain Liquidated Damages"
AICPA TPA section 1400.32 (Nonauthoritative)	"Parent-Only Financial Statements and Relationship to GAAP"
AICPA TPA sections 2130.09–2130.37 (Nonauthoritative)	These TPA sections discuss various topics on the application of SOP 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer.*
AICPA TPA sections 1400.29–1400.31 and 1500.06 (Nonauthoritative)	These TPA sections discuss various topics regarding FASB Interpretation No. 46(R) on variable interest entities.
AICPA TPA sections 6910.16–6910.20 (Nonauthoritative)	These TPA sections discuss nonregistered investment partnerships topics.
AICPA TPA sections 5600.07–5600.17 (Nonauthoritative)	These TPA sections discuss various lease topics.

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COSO Internal Control Over Financial Reporting—Guidance for Smaller Public Companies	The guidance provides a set of 20 basic principles representing the fundamental concepts associated with and drawn directly from the five components of internal control described in the COSO Internal Control Framework.

Of the pronouncements and other guidance listed in the previous table, those having particular significance to the insurance industry are briefly explained here. The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The AICPA general *Audit Risk Alert—2006/07* and other AICPA industry-specific Alerts also contain summaries of recent pronouncements not discussed here. To obtain copies of AICPA literature, call the AICPA Service Center Operations at (888) 777-7077 or go online at www.cpa2biz.com.

FASB Statement No. 157, *Fair Value Measurements*

In September 2006, the FASB issued FASB Statement No. 157 to provide enhanced guidance for using fair value to measure assets and liabilities. The standard applies whenever other standards require (or permit) assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early adoption is permitted.

FSP FTB 85-4-1, *Accounting for Life Settlement Contracts by Third-Party Investors*

This FSP provides initial and subsequent measurement guidance and financial statement presentation and disclosure guidance for investments by third-party investors in life settlement contracts. As noted in paragraph 5 of the FSP, an investor may elect to account for its investment in life settlement contracts using either the investment method or the fair value method. This FSP also amends certain provisions of FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance,* and FASB Statement No. 133.

The guidance in this FSP shall be applied to fiscal years beginning after June 15, 2006. An investor shall apply the guidance prospectively for all new life settlement contracts. At the date of adoption, an investor shall make a one-time irrevocable election to account for its currently held life settlement contracts on an instrument-by-instrument basis using either the fair value method or the investment method and recognize a cumulative-effect adjustment to beginning retained earnings.

EITF Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"

This EITF issue addresses how an employer should account for the deferred compensation or postretirement benefit aspects of split-dollar life insurance arrangements. The EITF issue pertains to entities with endorsement split-dollar life insurance arrangements that provide the employee with a specified benefit that is not limited to the employee's active service period (that is, it extends into postretirement). The structure of a split-dollar life insurance arrangement can be complex and varied. In a typical endorsement split-dollar arrangement, the employer owns the policy and all rights of ownership, including the right to terminate the policy at any time. As a benefit of employment, the institution endorses over to the employee (the employee designates a beneficiary) a portion of the specified benefit.

The EITF concluded that the specified benefit associated with the endorsement split-dollar life insurance arrangement has not been settled upon entering into such an arrangement and as a result, the employer should recognize a liability for future benefits based on the substantive agreement with the employee. Therefore, the use of an investment product to fund a deferred compensation arrangement does not prevent the need to accrue the obligation presented by the deferred compensation arrangement; note that a liability for the benefit obligation has not been settled through the purchase of an endorsement-type policy. The consensus in this EITF issue is effective for fiscal years beginning after December 15, 2007, with earlier application permitted.

EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4"

EITF Issue No. 06-5, "Accounting for Purchases of Life Insurance—Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4," concluded on three issues. First, when determining the amount that can be realized in an insurance contract, the policyholder should consider any additional amounts, beyond the cash surrender value, included in the contractual terms of the policy. Second, the amount that can be realized under the insurance contract should be determined based on the assumed surrender value at the individual policy or certificate level, unless all policies (or certificates) are required to be surrendered as a group. Any amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized. Third, in measuring the cash surrender value, the task force concluded when it is appropriate to discount the cash surrender value. This EITF issue is effective for fiscal years beginning after December 15, 2006. Earlier application is permitted as of the beginning of a fiscal year for periods in which interim or annual financial statements have not yet been issued.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the insurance industry or that may result in significant changes. Read the AICPA general *Audit Risk Alert—2006/07* for a more complete list of ongoing auditing and accounting projects. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
National Association of Insurance Commissioners (NAIC)	www.naic.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Proposed Amendment to SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities

The ASB has issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69, The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, for Nongovernmental Entities. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles.* The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69 [AICPA, *Professional Standards,* vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the FASB proposed Statement, which can be obtained at www.fasb.org.

Proposed SSAE Regarding Reporting on an Entity's Internal Control Over Financial Reporting

In January 2006, the ASB issued a revised exposure draft of a proposed SSAE that would supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards,* vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned earlier, in December 2006, the PCAOB exposed for public comment a proposed auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* to supersede the current Auditing Standard No. 2. Because the forthcoming changes to Auditing Standard No. 2 will be relevant to the revision of AT section 501, the ASB has decided to defer to issuance of final revised AT section 501 until the PCAOB issues their amendments and the ASB has time to consider them.

Auditing Pipeline—Public Companies

Guidance issued by the PCAOB is included in the section of this Alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." Readers may also refer to the "SEC and PCAOB Update" section of this Alert for a brief overview of some significant ongoing SEC and PCAOB projects. For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert 2006/07* (product no. 022497kk), mentioned previously.

Accounting Pipeline

Presented below are accounting pronouncements currently in the exposure process. Some of the proposed pronouncements discussed in the prior year Alert have not been finalized as of the date of this writing, and thus are included below.

FASB Risk Transfer Project

As mentioned in the "Reinsurance Arrangements" section of this Alert, the FASB issued an invitation to comment on "Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting" in May 2006 with a comment period that ended in August 2006. The purpose of the invitation to comment was to gather input from buyers and sellers of insurance and reinsurance contracts and the users of their financial statements about the possible bifurcation of those contracts. The FASB was seeking to gather information about whether bifurcation of certain contracts and accounting for the financing element as a deposit would improve financial reporting by providing users of financial statements with better information about the economic substance of insurance arrangements.

At its December 6, 2006, meeting, the FASB decided that it would no longer pursue the issue of bifurcation of insurance and reinsurance contracts for financial reporting as part of its discussions relating to its insurance risk transfer project. The FASB decided the risk transfer project should focus on developing enhanced insurance and reinsurance disclosures that highlights any risk-limiting features included in those contracts, and to also work on developing additional language around the current FASB Statement No. 113 guidance to increase the level of risk transfer required for a contract to be accounted for as insurance. Information on the status of this project can be found on the FASB's Web site at www.fasb.org/project/insurance_risk_transfer.shtml.

FASB Project on Derivative Disclosures

FASB Statement No. 133 has been criticized by certain analysts, auditors, investors, and others for lacking transparent disclosures, allowing a user of the financial statements to assess the overall risk of derivatives on a reporting entity from both a quantitative and qualitative perspective. An exposure draft was issued on December 8, 2006, titled, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133.* The comment deadline is March 2, 2007. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133. The proposed disclosures will be effective for both interim and annual reporting periods ending after December 15, 2007, with early application encouraged. At initial adoption, disclosures for earlier periods presented for comparative purposes will be encouraged but not required. Disclosures for earlier periods presented for comparative purposes will be required beginning in the first year after the year of initial adoption. Auditors can monitor the progress of this project on the FASB's Web site.

FASB Business Combination Projects—Insurance Overview

On June 30, 2005, the FASB, jointly with the International Accounting Standards Board (IASB), issued for comment two exposure drafts: proposed Statements of Financial Accounting Standards, *Business Combinations—a Replacement of FASB Statement No. 141,* and *Consolidated Financial Statements, Including*

Accounting and Reporting of Noncontrolling Interests in Subsidiaries—a replacement of ARB No. 51. The FASB's target date for issuing the final standards is mid-2007. The FASB and IASB will review the target effective dates of the Statements near the end of deliberations.

In these proposed Statements, the FASB plans to revise the existing guidance on the application of the purchase method. The following are among the main proposals:

1. Business combinations would be measured and recognized as of the acquisition date at the fair value of the acquiree. This would apply to step acquisitions and partial acquisitions (those in which less than 100 percent of the equity interests in the acquiree are acquired at the acquisition date).
2. The assets acquired and liabilities assumed would be measured and recognized at their fair values as of the acquisition date, with limited exceptions.
3. A new definition of a business would amend the definition provided in International Financial Reporting Standard (IFRS) 3, *Business Combinations,* and nullify the definitions provided in EITF Issue No. 98-3, "Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business," and FASB Interpretation No. 46.
4. In a step acquisition, the acquirer would remeasure its preacquisition noncontrolling equity investments to fair value at the acquisition date and would recognize any gain or loss in income.
5. If the acquisition date fair value of the acquirer's interest in the acquiree exceeds the fair value of the consideration transferred for that interest, the excess would first be recognized as a reduction of any goodwill until goodwill is reduced to zero then any remaining excess would be recognized in income.

6. Any measurement period adjustments to the provisional values recognized for the assets acquired and liabilities assumed would be recognized as if the accounting for the business combination had been completed at the acquisition date. Therefore, comparative information for prior periods would be adjusted.

Short-Duration Contracts. The business combinations exposure draft states that short-duration insurance contract claim liabilities assumed in a business combination should be measured at fair value at the date of acquisition. Paragraph A49 of the business combinations exposure draft explains that FASB Statement No. 60, as amended by paragraph D13 of the exposure draft, requires an expanded presentation that splits the fair value of acquired insurance contracts into two components:

1. A liability measured in accordance with the insurer's accounting policies for short-duration insurance contracts that it issues

2. An intangible asset, representing the fair value of the contractual rights and obligations acquired, to the extent that the liability does not reflect that fair value. This intangible asset is excluded from the scope of FASB Statement 142, *Goodwill and Other Intangible Assets,* and FASB Statement 144. After the business combination, the acquirer is required to measure that intangible asset on a basis consistent with the measurement of the related insurance liability.

The business combinations exposure draft also provides guidance for "Day 2" accounting in paragraph 36. After initial recognition, contingencies shall be accounted for as follows:

a. A contingency that would be accounted for in accordance with FASB Statement No. 5 if it were acquired or incurred in an event other than a business combination shall continue to be measured at fair value with any changes in fair value recognized in income in each reporting period.

b. All other contingencies shall be accounted for in accordance with GAAP. For example:

   1. A contingency that is a financial instrument shall be accounted for in accordance with applicable financial instrument guidance.
   2. A contingency that is an asset or liability arising from an insurance contract shall be accounted for in accordance with FASB Statement No. 60, as amended (including the intangible asset, if any, recognized for the difference between the amounts recognized on the acquisition date at fair value and the amounts that would be recognized in accordance with FASB Statement No. 60).

FASB Fair Value Option Project

In the FASB's fair value project, it is considering whether to permit entities a one-time election to report certain financial instruments (and perhaps similar nonfinancial instruments) at fair value with the changes in fair value included in earnings. The fair value option project has been divided into two phases. This proposal, issued January 25, 2006 and titled *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115,* represents phase one of the project. The exposure draft's comment period ended April 10, 2006. Phase one addresses the fair value option for certain financial assets and financial liabilities. Phase two will consider permitting the fair value option for certain nonfinancial assets and nonfinancial liabilities and some of the financial assets and financial liabilities excluded from the scope of phase one.

The proposed Statement would create a fair value option under which an entity may irrevocably elect fair value as the initial and subsequent measurement attribute for certain financial assets and financial liabilities on a contract-by-contract basis, with changes in fair value recognized in earnings as those changes occur. The proposed Statement has specific financial presentation requirements to display fair values and those values that are measured using other measurement techniques. The proposed Statement would amend FASB Statement No. 115 to require that securities reported at fair value in accordance with FASB Statement No. 115 satisfy the specific financial statement presentation requirements.

The exposure draft noted that insurance and reinsurance contracts that are financial instruments, as discussed in FASB Statements No. 60, No. 97, and No. 113, would be included in the scope of the fair value option project. Questions have been submitted to the FASB asking which insurance and reinsurance contracts would be considered financial instruments, and recommending that the final guidance clearly state the criteria to be used in determining which insurance and reinsurance contracts should be designated as financial instruments to avoid significant inconsistency in application of this Statement. During the FASB's redeliberations which began in August 2006, the FASB tentatively decided that insurance and reinsurance contracts that meet the definition of a financial instrument will remain in the scope of phase one, and the scope of phase one will be expanded beyond insurance and reinsurance contracts that are financial instruments to also include insurance contracts that do not prohibit settlement of the insurer's obligation by payment to a third-party provider of goods or services rather than by payment to the insured or other claimant.

The FASB tentatively projects a final Statement for phase one will be issued during the first quarter of 2007. FASB activity on phase two will begin after a final Statement has been issued for phase one. Visit the FASB Web site at www.fasb.org/project/index.shtml for additional information.

FASB Financial Guarantee Insurance Project

The objective of this project is to provide guidance with respect to the timing of claim liability recognition, premium recognition (including accounting for installment premiums), and the related amortization of deferred policy acquisition costs, specifically for financial guarantee contracts issued by insurance companies that are not accounted for as derivative contracts under FASB Statement No. 133. A financial guarantee contract guarantees the holder of a financial obligation the full and timely payment of principal and interest when due and is typically issued in conjunction with municipal bond offerings and certain structured finance transactions. The goal is to reduce diversity in accounting by financial guarantee insurers, thereby enabling users to better understand and more readily compare the insurers' financial statements. An exposure document is expected to be issued by the FASB in the first quarter of 2007.

IASB and FASB Modified Joint Project on Accounting for Insurance Contracts

The IASB and the FASB have agreed to approach a project on accounting for insurance contracts using the modified joint approach. The IASB will issue for public comment a discussion paper containing its tentative decisions on the accounting for insurance contracts. The FASB plans to seek input from its constituents on the IASB's preliminary views by issuing an invitation to comment containing the IASB discussion paper. The feedback received on that invitation to comment will be used by the FASB in deciding whether to add to its agenda a joint project with the IASB to develop a comprehensive standard on accounting for insurance contracts. The IASB expects to issue its discussion paper in the first quarter of 2007; the FASB also expects to issue its invitation to comment during the first quarter 2007.

FASB Exposure Draft, *Accounting for Transfers of Financial Assets*

The exposure draft *Accounting for Transfers of Financial Assets* is a revision of a June 2003 exposure draft, *Qualifying Special-Purpose Entities and Isolation of Transferred Assets,* and would amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125.* The proposed Statement seeks to:

1. Clearly specify the permitted activities of a qualifying special-purpose entity (QSPE).

2. Address practice issues related to which arrangements should be considered and how they should be considered in the legal isolation analysis.
3. Eliminate the prohibition on a QSPE's ability to hold passive derivative financial instruments that pertain to beneficial interests held by a transferor.
4. Revise the methodology used to initially measure at fair value interests related to transferred financial assets held by a transferor.
5. Clarify guidance related to when rollovers of beneficial interests are permitted within a QSPE.

At its October 18, 2006 meeting, the FASB continued redeliberations on the exposure draft and discussed whether and how to amend the isolation guidance in FASB Statement No. 140. The FASB decided to amend the isolation criteria in paragraph 9(a) of FASB Statement No. 140 for consolidated financial statements that include a transferor by requiring that the legal analysis treat all of the involvements in the transferred financial assets by any entity that is included in the consolidated financial statements being presented as if those involvements were made by the transferor. In order for a parent entity of a transferor to meet the isolation requirement, an isolation analysis must conclude that the transferred financial assets would be beyond the reach of all of the entities (and their creditors) included in the financial statements being presented, using the assumption that all of the involvements of the entities were made by the transferor. The FASB expects to issue a final Statement, which would amend FASB Statement No. 140, in the second quarter of 2007. See the FASB Web site for complete information.

Proposed FASB Statement, *The Hierarchy of Generally Accepted Accounting Principles*

This proposed Statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AU section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles (AICPA, *Professional Standards,* vol. 1). However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, who is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonpublic Companies" section of this Alert) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final Statement.

At the August 2006 meeting, the FASB discussed certain GAAP hierarchy issues that were raised by constituents subsequent to redeliberations on the FASB exposure draft *The Hierarchy of Generally Accepted Accounting Principles.* The FASB decided that:

- The grandfathering provisions related to EITF Issues and SOPs in SAS No. 69 should not be included in the final Statement.
- EITF D-Topics will be explicitly included in category (c) of the GAAP hierarchy. Additionally, a footnote will be added that states that SEC observer comments are accounting principles for SEC registrants.
- A near-final version of the proposed Statement, including all of the FASB's decisions made during redeliberations, will be posted to the Web site.

Again, the FASB staff will coordinate with the AICPA and the PCAOB in order to ensure that each of the documents has a uniform effective date.

Derivatives TPA

The Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force and AICPA staff have issued a working draft of the TPA titled "Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments." This TPA is nonauthoritative, is a working draft, and reflects existing authoritative literature as of December 1, 2006. It can be accessed at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm.

Proposed FASB EITFs and FSPs

Proposed FASB EITF Issues. Numerous open issues are under deliberation by the EITF. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

Proposed FSPs. A number of proposed FSPs are currently in progress. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/proposed_fsp.shtml for complete information.

Resource Central

The following are various resources that practitioners engaged in the insurance industry may find beneficial.

Publications

- Audit and Accounting Guide *Life and Health Insurance Entities* (2006) (product no. 012636kk). This Guide summarizes applicable practices and delivers "how-to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the insurance industry and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- Audit and Accounting Guide *Property and Liability Insurance Companies* (2005) (product no. 012675kk). This Guide summarizes applicable practices and delivers "how-to" advice for handling almost every type of financial statement. It describes relevant matters, conditions, and procedures unique to the insurance industry and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk). This Guide will assist practitioners in applying the auditing standards related to the assessment of risk in an audit of financial statements. This Guide provides both authoritative and nonauthoritative guidance on applying the audit risk standards and addresses. The Guide also provides guidance on, among other things:

  - Key concepts underlying the auditor's risk assessment process
  - Planning and performing risk assessment procedures
  - Understanding the client, its environments, and its internal control
  - Linking risk assessment and the design of further audit procedures
  - Performing further audit procedures
  - Evaluating audit findings, audit evidence, and internal control deficiencies

In addition, the Guide offers many useful appendixes and an in-depth illustrative case study. Plus, the existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit* has been incorporated into this new Guide.

- Audit Guide *Analytical Procedures* (2006) (product no. 012556kk).You will receive guidance on the effective use of analytical procedures with an emphasis on analytical procedures as substantive tests. This 2006 Guide includes AU section 329 concepts and definitions, a questions-and-answers section, an illustrative case study, and a new appendix that includes useful financial ratios.

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2006) (product no. 012526kk). In this Guide, you will find an overview of derivatives and securities in addition to case studies to help you better understand how to audit derivative instruments.
- Audit Guide *Auditing Revenue in Certain Industries* (2006) (product no. 012516kk). This Guide assists auditors in fulfilling their professional responsibilities with regard to auditing assertions about revenue. In this edition, you will find:
    - Discussions on responsibilities of management, boards of directors, and audit committees for reliable financial reporting
    - Summaries on key accounting guidance regarding whether and when revenue should be recognized in accordance with GAAP
    - Circumstances and transactions that may signal improper revenue recognition
    - Procedures that the auditor may find effective in limiting audit risk arising from improper revenue recognition
- General *Audit Risk Alert—2006/07* (product no. 022337kk). This Alert will help you plan and perform your audits by identifying the significant business risks that may result in the material misstatement of your client's financial statements.
- *Compilation and Review—2006/07* (product no. 022307kk). This Alert updates CPAs on recent practice issues and professional standards that affect these types of engagements.
- *Independence and Ethics—2006/07* (product no. 022477kk). This Alert will inform you of recent developments in the area of independence and ethics for accountants. Specifically, this Alert will help you understand your

independence requirements under the AICPA Code of Professional Conduct and certain other rule-making and standard-setting bodies. A compact "plain English" digest of AICPA independence rules is also included. This alert includes information on guidance on the performance of nonattest services to attest clients, SEC independence rules, PCAOB independence and ethics activities, and GAO independence rules.

- *SEC and PCAOB Alert—2006/07* (product no. 022497kk). This Alert will prove useful for accountants working in public companies, auditors of public companies, or just the interested accountant who would like to remain current on issues affecting public companies. This Alert provides preparers and auditors with a detailed overview of recent developments at the SEC and PCAOB with respect to financial reporting and auditing matters.
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk). This Alert summarizes the eight risk assessment standards, highlights significant new requirements found in the standards, and helps you understand the many new requirements, including the following:
  - Auditors are to gather a sufficient understanding of the client and its environment, including its internal control, to allow for the better development of a tailored audit approach.
  - Auditors are to have an adequate basis of his or her audit approach, eliminating the default to a maximum control risk assessment.

This easy-to-read Alert gives you the right amount of information you will need to gain an understanding of the standards to begin incorporating the standards into your audit programs.

- AICPA Audit and Accounting Practice Aid *Illustrative Disclosures on Derivative Loan Commitments* (product no. 006642kk). SEC SAB No. 105, *Application of Accounting*

Principles to Loan Commitments, emphasizes that registrants should disclose their accounting policy for derivative loan commitments in accordance with APB Opinion No. 22. This Practice Aid provides illustrative disclosures under SEC Regulation S-K, Item 303; SEC Regulation S-K, Item 305; APB Opinion No. 22; FASB Statement No. 133; and FASB Statement No. 107.

- *Checklist and Illustrative Financial Statements for Life and Health Insurance Entities* (product no. 008956kk). This practice aid is invaluable to anyone who prepares financial statements and reports for life and health insurance companies. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements you are auditing.
- *Checklist and Illustrative Financial Statements for Property and Liability Insurance Entities* (product no. 008966kk). This practice aid is invaluable to anyone who prepares financial statements and reports for property and liability insurance companies. These disclosure checklists have been designed to help you prepare financial statements and assist you in determining the adequacy of disclosures in the financial statements you're auditing.
- *Audit and Accounting Manual* (2006) (product no. 005136kk) is developed exclusively for small-and medium-size CPA practices. This unique manual explains and demonstrates useful techniques and procedures for conducting compilation, review, and audit engagements—from planning to internal control to accountants' reports.
- *Accounting Trends & Techniques, 60th Edition* (product no. 009898kk). This is the must-have resource for any CPA who frequently creates or uses financial reports. Filled with current reporting techniques and methods used by the nation's top organizations, this 650-page AICPA bestseller will provide the guidance you need to improve your accounting preparation and procedures.

AICPA reSOURCE: Accounting and Auditing Literature

AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards,* TPAs, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques.* To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following. Visit www.cpa2biz.com for a complete list of CPE courses.

- *AICPA's Annual Accounting and Auditing Update Workshop* (2006 Edition) (product no. 736182kk [text] or 187190 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *SEC Reporting* (product no. 736773kk [text] or 186754 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

Online CPE

AICPA CPExpress (formerly InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 for nonmembers) for a new subscription and $119 ($319 for nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high-quality two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

The CFO Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting and budgeting and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. You can reach the Technical Hotline at (888) 777-7077.

Ethics Hotline

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

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This Audit Risk Alert replaces *Insurance Industry Developments—2005/2006.*

The Audit Risk Alert *Insurance Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to aeubanks@aicpa.org or write to:

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Appendix—Additional Web Resources

Here are some useful Web sites that may provide valuable information to accountants.

Web Site Name	*Content*	*Web Site*
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, Guides, Practice Bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Accounting+and+Review+Services+Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Professional+Issues+Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov

Web Site Name	*Content*	*Web Site*
Government Accountability Office (GAO)	Policy and guidance materials, reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
National Association of Insurance Commissioners (NAIC)	Information on regulation of the insurance industry	www.naic.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing the activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the EDGAR database	www.sec.gov